some more appropriate level.[157] At bottom, this position is indistinguishable from proposals for rate reinitialization, except that it contemplates phasing in the reinitialized rates over a period of several years.[158] This position would thus be untenable for all the reasons that reinitialization would be untenable: the ARMIS figures are meaningless, and in any event lowering price caps to some prescribed rate-of-return would present the same severe policy concerns as explicit rate-of-return regulation.[159] Indeed, the Commission has previously rejected proposals for an X-factor "explicitly linked to earnings" on the ground that they seek rate-of-return regulation in disguise.[160]

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157 *See* Nextel Comments at 19; Ad Hoc Comments at 43-44. Nor is there any reason to think that the difference between ARMIS-based apparent rates of return and the non-price-cap LECs' 11.25 percent rate represents any kind of real productivity gains. *See* Reply Declaration of John C. Klick and Michael R. Baranowski on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on July 29, 2005, at ¶ 24 ("Klick & Baranowski Reply Decl.") (Tab E); *cf.* Ad Hoc Comments at 43-44. Even assuming *arguendo* that an 11.25 percent rate of return were the right target, the largest share of the overage is likely attributable not to productivity gains, but to the ARMIS's billion-dollar errors in misallocating carrier investments. *See* Klick & Baranowski Reply Decl. ¶¶ 24-25.

158 For example, Ad Hoc's suggestion that the Commission calculate an "implicit X-factor" from the difference between ARMIS-based apparent rates of return and some target rate is simply a prescription for reinitializing rates, not a serious effort to calculate ILEC productivity. *See* Klick & Baranowski Reply Decl. ¶¶ 21-23. Ad Hoc's further suggestion that the Commission previously endorsed this kind of "implicit X-factor" calculation is overstated. *See* Ad Hoc Comments at 43-46. At most, the Frentrup-Uretsky study to which Ad Hoc refers was only one of several pieces of data the Commission considered in the early 1990s in setting its initial, and then interim, X-factors. *See Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1198, 1200 (D.C. Cir. 1996). When the Commission later attempted to set a permanent X-factor, it abandoned the Frentrup-Uretsky model altogether. *See X-Factor Decision*, 188 F.3d at 525-26; *Fourth Price Cap Performance Review Order* at 16654 ¶ 23.

159 *See* Klick & Baranowski Reply Decl. ¶¶ 21-23.

160 *Fourth Price Cap Performance Review Order* at 16654 ¶ 22 (rejecting AT&T's proposal for adoption of "the Historical Revenue Method on a moving-average basis").

The traditional rationale for adopting an X-factor is also absent, because the record contains no basis for concluding that price cap LECs will predictably increase their productivity more rapidly than businesses in the economy as a whole. For one thing, the BOCs' average enterprise-wide rate of return *declined* from approximately 16 percent in 1999 to 13 percent in 2004—not a trend one would expect to see from firms in the process of exploiting ever-greater productivity gains.[161] Also, there is no reason to suppose that the particular special access services subject to price caps will achieve continuing productivity gains, much less gains that outstrip average gains elsewhere in the economy.[162] To the contrary, the DSn-level services principally subject to price caps are typically provided by means of older, copper-based technologies and fiber facilities dedicated to individual customers, both of which are unlikely to experience the productivity gains of other fiber-based or wireless services.[163]

Nor do the commenters suggest how the Commission could calculate an X-factor even if it were justified in adopting one. Ad Hoc claims that "where the X is being designed to apply *only* to the special access basket, use of an X-Factor based upon firm-wide productivity rather than an X-Factor based upon the production of special access services within the firm will necessarily result in an X that is wrong for special access."[164] But establishing a special-access-specific X-factor would require accurate cost data specific not only to special access services

161 *See* Toti Initial Decl. ¶ 39.

162 *See* SBC's Opening Comments at 40-42; Klick & Baranowski Initial Decl. ¶¶ 18-20.

163 *See* Klick & Baranowski Reply Decl. ¶¶ 16-20; SBC's Opening Comments at 42; Kalt Initial Decl. ¶¶ 73-74; Klick & Baranowski Initial Decl. ¶ 20.

164 Ad Hoc Comments at 45-46.

generally, but to those services that remain subject to price caps, and no such data exist.[165] ARMIS is accurate only at the enterprise level, and the expense matrix data the BOCs have submitted are reported at the enterprise level as well.

Finally, the Commission may not just adopt some arbitrary X-factor and call it "interim." Even "interim" decisions require a basis in fact and logic.[166] Here there is no basis for concluding that the 5.3 percent figure some commenters propose,[167] which was first selected over 10 years ago on an *enterprise-wide basis* and long since abandoned,[168] is relevant to any increased productivity experienced by carriers today, given the radical technological and economic changes that have swept through the industry over the last ten years. Indeed, it would be surprising if there were any correlation at all between the productivity trends then and those now. And Ad Hoc's suggestion that the Commission adopt a 6.5 percent interim factor simply because the Commission previously used it as a "transitional mechanism"[169] is similarly baffling, given that the Fifth Circuit expressly held that this was an insufficient basis for maintaining such a figure.[170] "Even if the X-Factor is no longer tethered to any productivity measure, the FCC

165 *See* Klick & Baranowski Reply Decl. ¶¶ 24-25.

166 *See* SBC's Opening Comments at 46 & n.149 (citing case law).

167 *See*, API Comments at 12; Comments of AT&T Corp., filed in WC Docket 05-25, June 13, 2005, at 2 ("AT&T Comments"); CompTel Comments at 35-36; BT Americas Comments at 3; T-Mobile Comments at 21; Nextel Comments at 25; Letter from Paul Kouroupas, Global Crossing, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 05-25, at 1 (filed May 25, 2005); Letter from C. Douglas Jarrett, Keller and Heckman LLP, and Brian R. Moir, eCommerce & Telecommunications User Group, to Marlene Dortch, Secretary, FCC, WC Docket No. 05-25, at 1 (filed May 10, 2005).

168 *See Bell Atlantic*, 79 F.3d at 1202-03; *Fourth Price Cap Performance Review Order* at 16647-51 ¶¶ 4-11.

169 *See* Ad Hoc Comments at 54.

170 *See TOPUC*, 265 F.3d at 329.

still needs to provide a rational explanation of how it derived the precise percentage."[171] The D.C. Circuit also has rejected the Commission's earlier attempts to recycle an "old percentage" into a new X-factor,[172] and the current proposals to do just that would likely suffer a similar fate.

2. The record establishes no basis for imposing a g-factor.

For similar reasons, the Commission also should not impose any "g-factor" reflecting various predictions about future increases in the BOCs' economies of scale. Few non-ILEC commenters even address the g-factor, and those that do simply assert, without elaboration, that they want one.[173]

There is no evidence that ILECs will enjoy substantially increased scale economies in the provision of special access. The fact that line growth appears to be outpacing the growth in special-access expenditures *as reported in ARMIS* proves nothing about economies of scale, given ARMIS's massive understatement of those expenditures.[174] If anything, the record points in the opposite direction. The only lines that could be relevant to a g-factor inquiry are, of course, those subject to price caps. As noted, many of the DSn-level circuits covered by price caps consist of copper loops (*i.e.*, end-user channel terminations). But it is entirely unclear whether copper loops are exhibiting any increase at all in scale economies (and they are certainly not exhibiting any increase that even approaches those found, for example, in interexchange fiber

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171 *Id.*

172 *See X-Factor Decision*, 188 F.3d at 527.

173 *See* Ad Hoc Comments at 47 (recommending that the Commission "leave a holding place for the 'G' factor in any plan it may devise"); T-Mobile Comments at 19.

174 *Cf.* SBC's Opening Comments at 24-33; Toti Initial Decl. ¶¶ 16-41; Klick & Baranowski Initial Decl. ¶¶ 27-28.

facilities).[175] Because new demand in channel terminations typically requires deployment of new facilities, ILECs may actually be losing scale economies.[176] The ILECs' steady loss of market share to intra- and intermodal competitors, detailed above, also tends to reduce the ILECs' scale economies.[177] Finally, to the extent that increases in traffic volumes enhance ILEC scale economies, these economies are already largely built into SBC's pricing structure, and are thus already passed along to customers. For example, the average price of a 10-mile DS3 interoffice transport circuit is only about **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** times the average price of a 10-mile DS1 interoffice transport circuit, even though the DS3 provides bandwidth equivalent to 28 DS1s.[178]

C. The Triggers for Phase II Pricing Flexibility Do Not Need to Be Modified.

In its opening comments, SBC explained why the Commission should categorically grant Phase II pricing flexibility to OCn-level services and packet-switched services on a nationwide basis for all serving areas.[179] SBC further showed that, for the remaining services, the Commission should retain its existing triggers for Phase II pricing flexibility.[180] Many of the

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175 *See* Kalt Initial Decl. ¶¶ 73-74; Klick & Baranowski Initial Decl. ¶ 20.

176 *See* Casto Reply Decl. ¶ 40.

177 *See* Klick & Baranowski Initial Decl. ¶ 34. In *no* event could the Commission adopt both an X-factor and a separate g-factor, because that would produce double-counting by "including demand growth-related efficiencies in both the 'g' factor and the X-factor." *Special Access NPRM* at 2010 ¶ 40. If line growth is the accepted measure of output growth for special access lines, then the fact that line growth has outpaced growth in expenses—even if accurate—would simply be a measure of productivity improvement that would already be reflected in a productivity factor. Including this a second time as part of a g-factor would be illogical. *See* Klick & Baranowski Initial Decl. ¶ 37.

178 Casto Reply Decl. ¶ 41.

179 SBC's Opening Comments at 58-60.

180 *Id.*

same parties that advocate the elimination of Phase II pricing flexibility altogether argue that the Commission should, at a minimum, change the triggers for granting flexibility to make it more difficult for anyone to qualify.[181] Both of these arguments are without merit.

First, collocation figures continue to serve as reasonable and administratively feasible proxies for determining when competition in an area has developed to the point where price caps are unnecessary. The ubiquitous presence of new competitors in SBC's Phase II MSAs, together with declining average prices, vindicates the Commission's original conclusion that significant collocation—evidencing millions of dollars in investment by competitors—is a reliable indicator of lasting competition. If anything, experience has demonstrated that collocation is too *conservative* a measure of competition, since it misses intermodal competitors (such as cable and fixed wireless) and even much of the wireline competition (such as Type 1 services, and CLEC-to-CLEC connections outside LEC central offices).[182]

The various complaints about using collocation as a proxy are baseless. Time Warner Telecom claims that collocation *over-counts* actual competition for channel terminations, since a competitor collocates in an ILEC wire center "primarily for the purpose of gaining access to the ILEC[']s special access channel termination circuits or unbundled loops, *not* for constructing its own loop facilities."[183] That is wrong. To begin with, Time Warner *itself* has deployed fiber to customer premises in **[BEGIN CONFIDENTIAL INFORMATION] [END**

[181] WilTel Comments at 21-22; T-Mobile Comments at 15; Nextel Comments at 22.

[182] *See generally* Casto Initial Decl. (describing competitive pressures faced by SBC). *See also Pricing Flexibility Order* at 14280 ¶ 104 (concluding that "collocation is a conservative measure of competition in that it does not measure competition from competitors that bypass LEC facilities altogether").

[183] Time Warner Telecom Comments at 8 (emphasis in original).

CONFIDENTIAL INFORMATION] percent of the wire centers in which it is collocated.[184] More generally, when CLECs deploy fiber facilities, they seldom do so to provide a specific substitute for "loops" or "transport" standing alone. Rather, they deploy fiber rings in a target market to provide both loop and transport functionality, building spurs off of the rings to connect to individual customer premises and to connect to the ILEC's network.[185] As the Commission itself has observed, "fiber rings are often deployed to maximize the ability of competitors eventually to deploy loop facilities to connect directly buildings and customers to the transport ring, without accessing unbundled loops at the incumbent LEC central office."[186]

Second, there is no merit to proposals for narrowing the geographic scope of the triggers from MSAs to wire centers.[187] As a preliminary matter, a wire-center-based test would not necessarily track competitive conditions much better than an MSA-based test because the costs of deployment even to individual buildings varies greatly.[188] The regulatory goal, then, is to "define these geographic areas narrowly enough so that the competitive conditions within each

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184 Casto Reply Decl. ¶ 47.

185 *Id.* ¶ 53.

186 *Triennial Review Order* at 17207 ¶ 370. See also *Pricing Flexibility Order* at 14280 ¶ 104 ("It . . . seems likely . . . that the extent to which competitors have collocation arrangements in an MSA is probative of the degree of sunk investment by competitors in channel terminations between the end office and the customer premises throughout the MSA."). WilTel makes a similar argument that competitors may collocate for their own purposes, without intending to sell special access services on the wholesale market. In fact, the evidence compiled in the *TRO* proceeding confirms that even where providers do not sell service on the open market, many of them sell to other CLECs. *See* Reply Comments of SBC Communications Inc., WC Docket No. 04-313 at 33 (filed Oct. 19, 2004).

187 *See* WilTel Comments at 21-22; T-Mobile Comments at 15; Nextel Comments at 22.

188 *See Triennial Review Remand Order* ¶ 155.

area are reasonably similar, yet broadly enough to be administratively workable."[189] And as the Commission recognized when it chose the MSA as the relevant market, "the costs, particularly the administrative costs, of granting pricing flexibility on a wire center-by-wire center basis outweigh the benefits of protecting against [any] theoretical harms."[190]

This observation remains true today. The costs of implementing pricing flexibility for each of the over 11,000 wire centers would be enormous for both the Commission and for the price cap LECs, without any clear upside. First, contrary to the conclusory allegations of commenters who urge such a hyper-granular analysis, there is no evidence that BOCs take advantage of any "over-inclusiveness" of MSA-level determinations. SBC's base rates are offered on an MSA-wide basis, the MVP offers a region-wide volume discount, and SBC's contract tariffs are priced either MSA-wide, state-wide or region-wide.[191]

Second, these same commenters falsely assume that a special access "market" can somehow be built on a single route between two wire centers. This plainly ignores economic realties. First, as discussed, competition in the special access market arises on the basis of demand levels within broad geographic areas, across which competing providers deploy their fiber rings.[192] It makes no more sense to atomize the special access market into tens of

189 *Pricing Flexibility Order* at 14259 ¶ 71.

190 *Pricing Flexibility Order* at 14267 ¶ 83. *See also id.* at 14260 ¶ 72 ("MSAs best reflect the scope of competitive entry, and therefore are a logical basis for measuring the extent of competition."); *id.* at 14260 ¶ 74 ("[D]efining geographic areas smaller than MSAs would force incumbents to file additional pricing flexibility petitions, and, although these petitions might produce a more finely-tuned picture of competitive conditions, the record does not suggest that this level of detail justifies the increased expenses and administrative burdens associated with these proposals.")

191 Casto Reply Decl. ¶ 52.

192 *See id.* ¶¶ 53-54.

thousands of submarkets, each involving a single building, than to define any other market on such an absurdly granular basis. Second, just as important, the objective of the collocation measure is, quite sensibly, not to guarantee that every loop and transport route in an MSA is actively contested, but rather to show that actual or potential competition constrains prices as a general matter. Third, managing pricing flexibility on a wire-center basis would exponentially increase each ILEC's recordkeeping, reporting, and management overhead, and would significantly complicate the negotiation and implementation of contract tariffs.[193] Finally, the Commission itself would have to oversee each of the nation's more than 11,000 wire centers—a task no easier today than when the *Pricing Flexibility Order* was adopted.[194]

In advocating a wire-center-based trigger system, these parties propose the test for whether transport must be unbundled as a UNE as the model, but the Commission's adoption of wire-center-based impairment test for UNEs does not justify adoption of a similar test for determining pricing flexibility. Contrary to the suggestion of some commenters, it would be much more difficult and expensive for SBC to implement wire-center-by-wire-center pricing flexibility than wire-center-by-wire-center loop and transport UNE relief. This is because UNE availability can be "flipped off" at SBC's ordering systems when UNE relief is granted. With special access, however, the question is not whether it may be *ordered*, but how it is *priced*. Changing special access rates on a wire-center basis could not be done by inserting a few lines of code into SBC's ordering systems; it would require a complete and expensive overhaul of SBC's

193 *See id.* ¶¶ 55, 58.

194 As Mr. Casto describes, though the filings for each wire center would be slightly less complicated than MSA-based applications for price cap relief, the sheer number of filings would add considerably to the burdens of the Commission and its staff. *See id.* ¶ 57.

billing systems. Upgrading SBC's billing systems to allow for MSA-wide pricing flexibility has already cost SBC almost **[BEGIN CONFIDENTIAL INFORMATION] [END CONFIDENTIAL INFORMATION]** Shifting to wire-center-based pricing flexibility would render those enhancements worthless and subject SBC to even greater expenses before it could price on a wire-center basis.[195]

Finally, the existing triggers will continue to provide adequate protection even for lower bandwidth services and end-user channel terminations. The vast majority of commenters that seek re-regulation of special access services focus exclusively on lower-bandwidth offerings—DS1 and DS3—and several urge more specialized price flex triggers to protect these market segments.[196] Such changes—which would only further complicate the regulatory regime—are unnecessary. Where collocation triggers for channel terminations have been met, competition is growing even in less dense portions of the MSAs. First, it is not at all easy for ILECs to achieve pricing flexibility for these services; SBC's pricing flexibility for end user channel terminations is limited largely to its two most "wired" MSAs: San Jose and Los Angeles. SBC has not been able to achieve pricing flexibility for end user channel terminations in other large cities such as St. Louis, Dallas, Houston, Detroit, Cincinnati, Cleveland, Chicago, San Diego, and San Francisco, despite the presence of several major competitors in each of those markets.[197] More fundamentally, as the fiber maps submitted by Mr. Casto reveal, competitors are laying fiber not

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195 *Id.* ¶ 58.

196 Sprint Comments at 9; Time Warner Telecom Comments at 22; T-Mobile Comments at 16.

197 Casto Reply Decl. ¶ 60.

only in Tier II and III MSAs, but also in outlying areas such as Aurora, Illinois.[198] Thus, actual market behavior has vindicated the Commission's 1999 conclusion that:

> the extent to which competitors have collocation arrangements in an MSA is probative of the degree of sunk investment by competitors in channel terminations between the end office and the customer premises throughout the MSA. . . . Given the lack of other data in the record, therefore, we conclude that it is reasonable to rely on collocation as a proxy for irreversible, sunk investment in channel terminations between the end office and the customer premises and to set the applicable thresholds high enough to account for the limitations inherent in this trigger.[199]

D. The FCC Should Encourage, Not Deter, ILEC Discount Plans.

A handful of parties challenge various ILEC discount plans as "exclusionary."[200] Some criticize plans that extend certain discounts only to customers willing to commit to particular volume levels. Others criticize plans on grounds that they "bundle" services across product categories and geographic boundaries. These types of discount packages—volume discounts, bundled discounts, and so forth—are ubiquitous throughout the economy, including in highly competitive markets.[201] Indeed, CLECs themselves offer such packages.[202]

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198 *See* Casto Initial Decl., Attach. 1.

199 *See, e.g., Pricing Flexibility Order* at 14280 ¶ 104.

200 Broadwing/SAVVIS Comments at 23-24; CompTel/ALTS Comments at 11-13.

201 *See* Timothy J. Muris, Comments on Antitrust Law, Economics, and Bundled Discounts, Submitted on Behalf of the United States Telecom Association in response to the Antitrust Modernization Commission's Request for Public Comments at 2 (July 15, 2005) ("Muris White Paper") (Tab A) ("The use of bundles to sell goods or services – that is, the sale of multiple items together, as well as separately – is ubiquitous throughout the American economy."); *see also id.* at 2-4 (listing examples); *see also* Kalt Reply Decl. ¶¶ 34-45 (describing pro-competitive use of such discounts).

202 *See* Broadwing/SAVVIS Comments at 26 ("If, for example, SAVVIS needs to terminate a specific circuit before the term of the contract is fulfilled, competitive providers typically do not charge a termination penalty . . . so long as SAVVIS' overall spend remains at or above the committed amount."). SBC, for example, has negotiated contracts with competitive special

The reason such bundled discounts arise so commonly in the free market is that they overwhelmingly increase both economic efficiency and consumer welfare. "Without a doubt, bundling generates many benefits for consumers. Bundled discount and rebate programs allow firms to offer desirable combinations of products that suit their particular needs and changing demands, while enabling both the customers and the supplier to avoid the information and transaction costs of a more particularized process." [203] And consumers benefit equally, if not more, when the firm granting the bundled discount has the largest share of the market. As the Supreme Court has held, "[l]ow prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition"—even when offered by firms with market power.[204] That conclusion is particularly compelling where, as in the special access market, the discounts are demanded by the purchasers, not remotely coerced by the sellers.

As SBC explained in its initial comments, moreover, relying on market forces to produce efficient discount plans is far preferable to adopting nebulous regulatory restrictions that deter firms from providing discounts in the first place.[205] As George Mason professor Timothy Muris explains, "any reliance on the theoretical exclusionary literature to prohibit or regulate bundled discounts is premature. While economic literature suggests the *possibility* of anticompetitive

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access providers out-of-region that provide significant discounts in return for revenue commitments that span multiple services across the country.

203 Muris White Paper at 4.

204 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 223 (1993) (quoting *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990)).

205 *See* SBC's Opening Comments at 51-52; *see also Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (1st Cir. 1983).

harm from certain bundling, there is little evidence that such harm is likely or that any potential for harm would outweigh any demonstrable benefits from the practice."[206] For that reason alone, the Commission should resist calls to use this proceeding as a forum for cataloguing and regulating the myriad different forms that discount plans can take. The legacy of any such endeavor would be a set of vague restrictions that discourage discounts and keep prices higher than efficient levels. To the extent the Commission addresses these discount plans in the future, it should do so only on a case-by-case basis with the benefit of a highly developed factual records relating to specific discount plans.[207]

On the merits, the various complaints about ILEC discount plans founder on the facts. Contrary to the rhetoric of some parties, for example, customers are never "effectively force[d]"[208] to buy services from ILECs that they could have obtained more cheaply on an a la carte basis from other providers, and these parties have not identified even a single instance in which a purchaser has forgone a lower-priced offer from a competitive provider in order to meet

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206 Muris White Paper at 8 (emphasis in original); *see also id.* at 19 ("Given our current state of knowledge, . . . the *Brooke Group* test [for predatory pricing] is the most sensible one to use to gauge the legality of multiproduct bundled discounts whenever used, by large firms or small, or by firms in unregulated or regulated industries.").

207 The Commission based its holding in *AT&T Corp. v. BellSouth Telecoms., Inc.*, 19 FCC Rcd 23898 (2004)—that a BellSouth volume discount plan discriminated in violation of BellSouth's long distance affiliate in violation section 272—on the particularized facts of that case: BellSouth's long distance affiliate was small and rapidly growing, and BellSouth's unaffiliated providers had large and mature market shares. Nothing in the *BellSouth Order* purported to address more generally the reasonableness of any discount structure under sections 201 and 202 of the Communications Act. The *BellSouth Order* is under appeal, moreover, and SBC does not support its reasoning.

208 CompTel/ALTS Comments at 12.

an incumbent's minimum annual volume commitment.[209] Indeed, on scores of occasions, SBC has offered steep discounts to potential customers, only to lose those customers to rivals (or self-deployment).[210]

Moreover, in SBC's experience, it is *customers* that demand bundled discounts, not the ILEC. In particular, SBC's customers have expressed a strong preference for region-wide, individually negotiated contract tariffs because those contracts facilitate the customers' marketing plans and greatly simplify the negotiation process.[211] SBC's customers similarly favor discounts on their aggregate demand for a variety of special access services in return for a volume or revenue commitment.[212] In short, the argument that an *ILEC* is leveraging its market position to obtain higher prices for competitive services has the market reality exactly backwards; it is typically the ILEC's *customer* that exploits its freedom to switch to alternative providers in wire centers with the most competitors to obtain higher overall discounts in other wire centers.[213]

209 *See, e.g.*, Broadwing/SAVVIS Comments at 23 (complaining generically that, as a result of the BOCs' discount plans, "it is difficult for Broadwing to procure special access circuits from competitive providers, even in locations where competitive providers have deployed facilities").

210 *See* Casto Initial Decl. ¶ 66 (providing examples of the 99 contract tariffs proposed by SBC and ultimately not pursued by prospective customer); Casto Reply Decl. ¶ 61 ("[T]hese customers continually make clear to SBC that they have competitive options; they use those options to extract price and other concessions from SBC during the negotiation process; and many times (unfortunately for SBC), they ultimately take their business elsewhere.").

211 *See* Casto Initial Decl. ¶¶ 70-71.

212 *Id.* ¶ 72.

213 *Id.* ¶ 68; Casto Reply Decl. ¶ 72.

Complaints about volume or revenue commitments in ILEC volume discount plans are particularly groundless, as SBC explained in its opening comments.[214] Harvard political economy professor Joseph Kalt observes that volume discounts with shortfall penalties are commonplace in competitive markets, a reliable indication that they are economically efficient.[215] Just as important, special access customers are not remotely constrained to subscribe to such plans in the first place. Indeed, customers can typically obtain large discounts off tariffed base rates without making volume or revenue commitments at all.

Under SBC's Term Payment Plan ("TPP"), for example, a customer who selects a one-year term would receive an 11 percent discount off of the month-to-month rate.[216] If the customer chooses a three or five year plan, it will receive a 41 percent or 45 percent discount, respectively.[217] Critically, the discount offered under SBC's optional five-year Managed Value Plan ("MVP"),[218] is an *overlay* discount, meaning it is an *additional* price break above and

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214 *See* SBC's Opening Comments at 50-57.

215 *See* Kalt Initial Decl. ¶ 46. Under take-or-pay contracts used in the natural resources (*e.g.*, natural gas) sector, customers (*e.g.*, utilities that resell gas) purchase volumes subject to the requirement that minimum volumes be paid for even if not taken by the buyer. Kalt Initial Decl. ¶ 46. Other examples of volume and term discounts include: the virtually universal practice of scores of magazine publishers offering discounts to consumers who commit to long-term subscriptions (relative to month-to-month spot purchases); discounts offered by innumerable independent home heating oil dealers if customers commit to an annual contract (as opposed to as-needed, single-delivery options); and the ubiquitous practice of apartment owners offering lower prices on longer-term rentals in exchange for loss-of-deposit penalties for the breaking of long-term leases. *See* Kalt Initial Decl. ¶ 46; *see also* Muris White Paper at 2-4.

216 *See* Casto Initial Decl. ¶ 59.

217 *See Id.* ¶ 59.

218 The MVP, among other terms, requires a minimum annual revenue commitment of 100 percent of the customer's purchases during the three months prior to entering the plan, annualized. *See* SBC's Opening Comments at 54 n.177 (providing additional details about MVP); Casto Initial Decl. ¶ 60.

beyond what the customer receives under SBC's other plans (such as the TPP).[219] The MVP's additional discount of 9 to 14 percent (the applicable percentage depends on the customer's plan year), although significant, is still a relatively modest fraction of the discount the customer otherwise obtains through a five-year TPP *without any minimum annual volume commitment whatsoever.* And customers have still the additional option of negotiating pricing flexibility contracts, also without any minimum annual volume commitment.[220]

In sum, the Commission should reject calls to restrict the ability of price-cap LECs to offer volume and term discounts for special access services—discounts that are wholly optional for customers and that resemble buyer-seller arrangements that routinely arise in competitive markets. To the contrary, the Commission should expand the discretion of price-cap LECs to offer innovative discount plans of all types, including those that encompass both interstate and intrastate services. Although SBC's special access customers are increasingly demanding such omnibus, jurisdiction-bridging discounts, SBC is generally unable to comply because of regulatory restrictions. Those restrictions place SBC at a competitive disadvantage vis-à-vis its special access competitors that do *not* face similar restrictions, given their virtually deregulated

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219 *See* Casto Initial Decl. ¶ 60.

220 *See* Casto Initial Decl. ¶¶ 64-65, 67 & Table 10. Indeed, SBC has entered into many such contracts. *See id.* ¶¶ 65, 67 & Table 10; Casto Reply Decl. ¶ 64. Even the MVP's minimum annual volume commitment potentially leaves a customer considerable flexibility to divert demand to other suppliers, because customers can and do enter into an MVP through one or more of its subsidiaries. Casto Initial Decl. ¶ 60. Thus customers can decide to include which of its subsidiaries to include for the purpose of calculating an minimum annual volume commitment, and may allocate future purchases among its subsidiaries to ensure that they meet the commitment. Indeed, the majority of subscribers to the MVP take advantage of this feature. MCI, for example, may purchase service through UUNET, Brooks Fiber, MFS, MCI Metro, WorldCom, or other subsidiaries. *Id.*

status. The Commission should eliminate this disparity by broadening the types of discounts that price-cap LECs are able to offer, a step that can only enhance consumer welfare overall.

CONCLUSION

The Commission should amend its price cap/pricing flexibility regime in the respects described above, and should more generally stay the deregulatory course by relying on market forces, rather than government intervention, to shape the future of special access services.

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I, Mary Beth Caswell, do hereby certify that true and accurate copies of the foregoing REDACTED PUBLIC VERSION of the Reply Comments of SBC Communications Inc. were served by hand delivery via courier this 29th day of July, 2005, upon:

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COMMENTS ON

ANTITRUST LAW, ECONOMICS, AND BUNDLED DISCOUNTS

SUBMITTED ON BEHALF OF THE

UNITED STATES TELECOM ASSOCIATION

IN RESPONSE TO THE

ANTITRUST MODERNIZATION COMMISSION'S REQUEST FOR PUBLIC COMMENTS

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I am Foundation Professor of Law, George Mason University School of Law. From June, 2001, through August, 2004, I was chairman of the Federal Trade Commission (FTC), the fourth position that I have held at the FTC.[1] I submit this comment about bundled discounts on behalf of the United States Telecom Association (USTelecom) and its member companies.[2]

SUMMARY

Applying antitrust to bundled discounts presents significant challenges. Although the practice is ubiquitous, the economic literature on it is underdeveloped, and the courts' experience is limited. Both the ubiquitous nature of the practice and the incomplete nature of our understanding suggest caution in using the antitrust laws. Yet, the Third Circuit's recent *LePage's* decision failed to exercise such caution. This decision, based on a poorly articulated theory and an incomplete record, could deter procompetitive behavior. Moreover, plaintiffs increasingly are relying on the vague and unsatisfactory *LePage's* analysis in circumstances clearly distinguishable from that case. This Commission and the courts should consider alternative rules that limit the decision's negative effect on the procompetitive uses of bundled discounts.

In developing these points, Section I describes the ubiquity of bundling and the wide variety of procompetitive reasons for which bundled discounts are used. Section II then examines the literature on bundling and its limited implications for antitrust policy. Section III critically discusses *LePage's*. Section IV considers the economic theories of anticompetitive harm used to justify scrutiny of bundled discounts. These theories and their assumptions are not only untested, but they also ignore the procompetitive reasons for which firms bundle. While these theories show the theoretical possibility of harm under limited conditions, they fall far short of proving that anticompetitive harm from bundling is likely or even that it is more than an antitrust unicorn. Sections V-VII consider potential rules, concluding that the *Brooke Group* standard, modified for bundled discounts, provides an administrable rule to incorporate the cautious and incremental approach that, under our current knowledge, best protects consumers.

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[1] I was previously Assistant to the Director of the Office of Policy Planning and Evaluation (1974-1976), Director of the Bureau of Consumer Protection (1981-1983), and Director of the Bureau of Competition (1983-1985).

[2] USTelecom is the nation's leading trade association representing communications service providers and suppliers for the telecom industry. USTelecom's carrier members provide a full array of voice, data, and video services across a wide range of communications platforms.

I. Selling Packages of Goods and Services Via Bundled Discounts Is Ubiquitous Across the American Economy and Is Valuable for Large and Small Producers and Consumers Alike in Every Type of Market

The use of bundles to sell goods or services – that is, the sale of multiple items together, as well as separately – is ubiquitous throughout the American economy. As one leading textbook notes: "Retailers bundle free parking with a purchase in their stores. Grocery stores and fast-food outlets bundle chances in games with purchase of their products. Newspapers with morning and evening editions bundle advertising space in both of them. * * * Symphony orchestras bundle diverse concerts into season subscription tickets. These are but a small fraction of the goods sold in bundles, but they illustrate the breadth of the practice – from commodities to services, from necessities to entertainment." Thomas T. Nagle & Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* 244-45 (3d ed. 2002) ("*Strategy and Tactics*"); *see also, e.g.*, David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, 22 Yale J. on Reg. 37, 41-42 (2005); Thomas A. Lambert, *Evaluating Bundled Discounts* 89 Minn. L. Rev. (forthcoming 2005) (Draft 1 n.2) (collecting citations).[3]

Firms also use bundling to enter new markets and compete effectively with established firms. For example, bundling is a major component of travel websites' strategy to compete with travel agents.[4] Moreover, airline websites encourage consumers to "save big by bundling" hotel and rental car reservations in a package with their airline tickets.[5] Cable companies attempt to compete with telecommunications companies by offering bundles of digital telephone service, high speed internet service, and digital cable.[6] Telecommunications companies have responded by offering discounts if consumers bundle their phone service with DSL and with satellite television. They also have expanded the number of product markets they are in so they may offer more attractive bundles.[7] The resulting bundle versus bundle competition will likely continue to drive down prices, increasing consumer welfare.

[3] *Accord* Ralph Fuerderer, Andreas Herrmann & George Wuebker, *Introduction to Price Bundling*, in Ralph Fuerderer, Andreas Herrmann & George Wuebker, *Optimal Bundling: Marketing Strategies for Improving Economic Performance* 3 (1999) ("Collecting goods or services as a package and selling them at a (discounted) price has become a widespread industrial sales practice in many production or service oriented industries."); Manjit S. Yadav, *How Buyers Evaluate Product Bundles: A Model of Anchoring and Adjustment*, 21 J. Consumer Res. 342, 342 (Sept. 1994) ("[f]irms frequently engage in bundling" of "both consumer and industrial products").

[4] *See* Missy Sullivan, *Vacation Wars*, Forbes.com, March 20, 2003, available at http://www.forbes.com/best/2003/0320/001_print.html, (discussing use of bundling by Expedia.com, Orbitz.com, and Travelocity.com).

[5] See http://www.united.com/page/article/0,6722,3761,00.html, visited July 1, 2005 (urging consumer to "Save big by bundling air+hotel+car together").

[6] See *Telephone Service and Bundle Strategy Fuels Engines for Cox Communications' Growth in 2003*, available at http://phx.corporate-ir.net/phoenix.zhtml?c=76341&p=irol-newsArticle&t=Regular&id=419186&.

[7] Nicholas Economides, *Telecommunications Regulation: An Introduction* (AEI-Brookings Joint Center for Regulatory Studies September 2003).

Bundling is a ubiquitous, but not a uniform, practice. The ubiquitous use of bundling in a wide variety of factual contexts stems from the large and varied reasons why bundling benefits both firms and consumers. "There are obvious business reasons why firms offer A and B together. These include benefits of integration, economies of scope in distributing products, packaging cost savings, reduced transaction costs for businesses and consumers, and increased reliability for consumers." David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. Chi. L. Rev. 73, 90 (2005); *see also, e.g.*, Daniel A. Crane, *Multiproduct Discounting: A Myth of Nonprice Predation*, 72 U. Chi. L. Rev. 27, 39-43 (2005).

One primary use of bundling is to give "bundled discounts" to consumers and to those who distribute and sell a firm's products – that is, consumers and retailers pay less when they purchase the entire package of goods, rather than just one or more components. Bundled discounts are everywhere -- used by established firms and new entrants, by firms at both retail and wholesale, by firms with and without market power, and by firms in regulated and unregulated industries. Although for variety in terminology, this comment sometimes refers to bundling as well as bundled discounts and bundled rebates, selling the package for less than the sum of the individual parts is the gravaman of the concern that the practice can violate the antitrust laws.[8]

It is easy to see why firms frequently bundle. By increasing sales, bundles enable firms to reduce production and inventory costs by taking advantage of scale economies, multi-item production synergies, and economies of scope.[9] Bundled pricing can also lower costs by reducing uncertainty about aggregate demand.[10] Bundling, moreover, can reduce overhead and marketing expenses, as well as economize on the quality signaling benefits of well-known brands.[11] Bundled discounts can substitute for advertising as a

[8] In the normal case discussed in this comment, the bundle price represents a true discount to the consumer relative to a world without bundling. A separate concern is the use of bundling as a de facto tie, where the stand-alone prices of the component goods are increased so that consumers purchase only the bundle. In such cases, the bundle price is discounted relative to the inflated stand alone prices, but does not yield a discount relative to the prices that existed or would have existed without bundling. While such cases of de facto tying are distinct from the normal case of bundling, and may in theory warrant separate treatment under the antitrust laws, they represent a narrow category of bundling that may not be easily distinguishable from other cases of bundling. Thus, separate treatment may be difficult and costly, requiring detailed evidence on prices that would have existed in the market but for the bundling. This issue is discussed in more detail in Section IV.B, *infra*.

[9] *See, e.g.,* William James Adams & Janet L. Yellen, *Commodity Bundling and the Burden of Monopoly*, 90 Q. J. of Econ. 475, 475-76 (1976); Michael S. Salinger, *A Graphical Analysis of Bundling*, 68 J. of Bus. 85 (1995); *Strategy and Tactics* 3, 306-07; Asim Ansari, S. Siddarth & Charles B. Weinberg, *Pricing a Bundle of Products or Services: The Case of Nonprofits*, J. Mktg. Res. 86-93 (1996); Hermann Simon & Georg Wuebker, *Bundling – A Powerful Method to Better Exploit Profit Potential*, in Ralph Fuerderer, Andreas Herrmann & George Wuebker, *Optimal Bundling: Marketing Strategies for Improving Economic Performance* 7, 13 (1999); Yannis Bakos & Erik Brynjolfsson, *Bundling Information Goods in Pricing, Profits, and Efficiency*, 45 Mgmt. Sci. 1613, 1619 (1999) ("Bundling can create significant economies of scope even in the absence of technological economies in production, distribution, or consumption.").

[10] Yannis Bakos & Erik Brynjolfsson, *Bundling and Competition on the Internet*, 19 Mktg. Sci. 63 (2002).

[11] *See, e.g.*, Michael A. Salinger, *A Graphical Analysis of Bundling*, 68 J. of Bus. 85 (1995).

short-term way to promote one or more products, especially new ones.[12] Bundled discounts also can facilitate efficiency-enhancing differential pricing.[13] Some manufacturers use bundling to reduce the divergence in incentives that exist between manufacturers and distributors.[14]

Without a doubt, bundling generates many benefits for consumers. Bundled discount and rebate programs allow firms to offer desirable combinations of products that suit their particular and changing demands, while enabling both the customers and the supplier to avoid the information and transaction costs of a more particularized process.[15] When firms use bundled discounts instead of advertising to increase demand, consumers benefit directly, both through decreased prices and because fewer societal resources are used.[16] Bundling reduces transaction and information costs for producers and consumers alike by, for example, use of one bill for all goods or services,[17] or by increasing the efficiency through which a firm's goods are distributed to customers.[18] Finally, as retailers increasingly consolidate and reduce the number of suppliers,[19] multi-product manufacturers find it correspondingly necessary to offer proconsumer bundled product discounts to keep retailers' business.[20]

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[12] Phillip E. Areeda, 9 *Antitrust Law* ¶ 1714b2, at 133-134 (2d ed. 2004); Phillip E. Areeda & Herbert Hovenkamp, 9 *Antitrust Law* ¶ 1714b2, at 135-36 (2d ed. 2004); Phillip E. Areeda, Herbert Hovenkamp & Einer Elhauge, 10 *Antitrust Law* ¶ 1758a, at 324 (2004).

[13] "Rather than cutting prices to price-sensitive customers, the value-added bundler instead offers them an additional value of a kind that less price-sensitive buyers do not want. With that strategy, a company can attract price-sensitive buyers without reducing prices to those who are relatively price insensitive." *Strategy and Tactics* 246; *see also* William J. Baumol, *Predation and the Logic of the Average Variable Cost* Test, 39 J.L. & Econ. 49, 65-67 & n.17 (1996) ("*Predation and Logic*") (noting circumstances in which economic efficiency requires the use of differential pricing); Richard Schmalensee, *Commodity Bundling by Single-Product Monopolies*, 25 J. Law & Econ. (1982); Stefan Stremersch & Gerald J. Tellis, *Strategic Bundling of Products and Prices: A New Synthesis for Marketing*, 66 J. Marketing 55, 70 (2002) ("[P]rice bundling of existing products * * * decreases price sensitivity and increases individual consumers' purchase likelihood."); George J. Stigler, *United States v. Loew's Inc.: A Note on Block-Booking*, 1963 Sup. Ct. Rev. 152, 153 (Using price discrimination to explain the block-booking of movies).

[14] *See, e.g.*, Roy W. Kenney & Benjamin Klein, *The Economics of Block Booking*, 26 J. L. & Econ. 497 (1983) (describing the use of block booking by Paramount and Loew's to reduce distributor agency costs and to minimize the costs of distribution).

[15] *See Strategy and Tactics* 245.

[16] Phillip E. Areeda & Herbert Hovenkamp, 9 *Antitrust Law* ¶ 1714b2, at 135-36.

[17] *Strategy and Tactics* supra at 245; *see also* Hermann Simon & Georg Wuebker, *Bundling – A Powerful Method to Better Exploit Profit Potential*, in Ralph Fuerderer, Andreas Herrmann & George Wuebker, *Optimal Bundling: Marketing Strategies for Improving Economic Performance* 13 (1999).

[18] *See* Kenney and Klein, supra n.14 at 524-27, 536-38.

[19] *See, e.g.*, Robert J. Vokurka, *Supplier Partnerships: A Case Study*, 39 Prod. & Inventory Mgt. J. 30 (1998); Philip B. Evans & Thomas S. Wurster, *Strategy and the New Economics of Information*, Harv. Bus. Rev. (Sept./Oct. 1997).

[20] *See, e.g.*, Chun-Hsiung Liao & Yair Tauman, *The Role of Bundling in Price Competition*, 20 Int'l J. of Indus. Org. 365 (Mar. 2002); Gary D. Eppen, Ward A. Hanson & R. Kipp Martin, *Bundling–New Products, New Markets, Low Risks*, Sloan Mgt. Rev. 7 (Summer 1991); Stefan Stremersch & Gerard J. Tellis, *Strategic Bundling of Products and Price: A New Synthesis for Marketing*, 66 J. Marketing 55, 70 (2002) ("We find that product bundling of existing products may be optimal because it creates added value for consumers, saves costs, and creates differentiation in highly competitive markets."); *Make a Bundle Bundling*, Harv. Bus. Rev. 18, 20 (Nov.-Dec. 1997) (quoting the author of one study of 100 companies for

Telecommunications firms are no exception to these principles. They engage in bundling just like, and for comparable reasons as, businesses that sell automobiles, vacations, or entertainment. Telecommunications companies offer discounts to customers that bundle services such as unlimited local calling, call waiting and call forwarding, unlimited long distance, a digital subscriber line, and wireless phone services.[21] As noted above, bundling is often a centerpiece of the competitive strategy of firms seeking to enter markets previously dominated by telecommunications firms, transforming the competitive landscape.[22] Moreover, it is clear that consumers desire bundled products: "70 percent of customers tell the Yankee Group that they want one-stop shopping" for telecommunications services.[23] Further, offering discrete bundles of services in groupings attractive to consumers may reduce communications costs for telecommunications companies and their customers alike.

II. The New Industrial Organization (IO) Literature on Bundling is Untested Empirically

Historically, bundled discounts were not deemed problematic or anticompetitive as a matter of economics or law as long as they did not constitute an illegal tying arrangement. The Supreme Court has distinguished tying from bundling by defining the former to include those cases in which the seller conditions the sale of the tying good upon the buyer agreeing to purchase the tied product from him. Practices by dominant firms that involve such coercion can be per se illegal. Bundling and other forms of packaged sales were thought to lack this coercive element, and were treated essentially as volume discounts, which are an unobjectionable type of promotional discount that lowers prices to consumers. *E.g., Concord Boat v. Brunswick Corp.*, 207 F.3d 1039, 1061 (8th Cir. 2000); Phillip E. Areeda & Herbert Hovenkamp, 3A *Antitrust Law* ¶ 768b2, at 149 (2d ed. 2002); Richard Posner, *Vertical Restraints and Antitrust Policy*, 72 U. Chi. L. Rev. 229, 240 (2005). Older economics literature also justified bundling on efficiency grounds, or explained the use of bundling as an economically innocuous form of price discrimination among consumers. *E.g.*, George J. Stigler, *United States v. Loew's Inc.: A Note on Block-Booking*, 1963 Sup. Ct. Rev. 152; William James Adams & Janet L. Yellen, *Commodity Bundling and the Burden of Monopoly*, 90 Q. J. of Econ. 475 (1976); Richard Posner, 72 U. Chi. L. Rev. at 235; *see generally* Daniel A. Crane, *Multiproduct Discounting: A Myth of Nonprice Predation*, 72 U. Chi. L. Rev. 27, 39-43 (2005). In

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the proposition that bundling reduces information and transaction costs for consumers: "When done correctly, bundling provides customers with simplicity and order in an otherwise chaotic world").

[21] *See, e.g.*, Ray Martin, *Save by 'Bundling'*, CBSNews.com, February 28, 2003, available at http://www.cbsnews.com/stories/2003/02/28/earlyshow/contributors/raymartin/main542428.shtml, (discussing savings from bundling phone, DSL, and wireless services).

[22] *See* the discussion in note 66, *infra*.

[23] Richard D. McCormick, Chairman of US West, *"Consumers Wanted Competition, But so Far It's No Contest,"* in J. Gregory Sidak, Ed., *Is the Telecommunications Act of 1996 Broken?* 117 (1999); *see also* Joel I. Klein, Assistant Attorney General – Antitrust, *"The Race for Local Competition: A Long-Distance Run, not a Sprint,"* in J. Gregory Sidak, Ed., *Is the Telecommunications Act of 1996 Broken?* 60, 67 (1999).

sum, bundling and bundled discounts were treated as a reasonable, procompetitive practice that aroused little antitrust concern.[24]

Recently, the economic literature has focused on alternative explanations for bundling by dominant firms. Some theoretical articles conclude that it is possible under specific conditions for multiproduct bundling to defeat the ability of an equally or more efficient firm to compete against a dominant firm in one or more of the component goods or services. *See generally* Daniel L. Rubinfeld, *3M's Bundled Rebates: An Economic Perspective*, 72 U. Chi. L. Rev. 243, 251-62 (2005) (discussing the literature). Based on these theoretical results, some have inferred that increased scrutiny of the use of distribution strategies that involve bundling by dominant firms is desirable. On one level, reliance on this recent scholarship would continue the strong influence economics has had on the antitrust laws. For the past 25 years, the discussion of antitrust policy in the microeconomic and industrial organization theory literature has greatly influenced antitrust law and policy. *E.g.*, *State Oil v. Khan*, 522 U.S. 3 (1997); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Continental T.V., Inc. v. GTE Sylvania*, 433 U.S. 36 (1977); *Town of Concord v. Boston Edison Co.*, 915 F.2d 17 (1st Cir. 1990) (Breyer, J.).

The literature's influence, however, is not uniform. Some academic scholarship has had great influence on competition policy. One example is New Institutional Economics (NIE), which seeks to extend and enrich understanding of the micro-analytic details of business behavior and the industry settings that shape firm conduct.[25] Policy analysis based on this literature reflects careful, fact-based analyses that properly account for institutions and all the relevant theories, not just market structure and market power theories.

Other literature has had relatively little influence. For example, the mathematical IO literature illuminates how substantial market power might be exercised, assuming it exists. In contrast to the NIE approach, it identifies and considers few bases for business decision-making other than market power, thereby greatly overemphasizing the importance of such power. Perhaps as a result of this focus, and also in contrast to the NIE literature, its influence has been limited. Because of the preoccupation with market power, one can find theoretical support for using antitrust law to stop almost any practice, including predatory pricing at prices above costs, tying as a monopolizing device, and even pricing practices covered by the Robinson-Patman Act.[26] But a theory that can

[24] Prior to the Third Circuit's recent decision in *LePages v. 3M*, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S. Ct. 2932 (2004), there was only one reported decision in the Federal Courts that condemned the use of bundled rebates on antitrust grounds. *See SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978), discussed in the text accompanying notes 48-50. In the only other case involving an antitrust challenge to the use of bundled rebates, the defendant prevailed on summary judgment. *See Ortho Diagnostic Systems, Inc., v Abbot Labs., Inc.* 920 F. Supp. 455, 471 (1996).

[25] *See* Timothy J. Muris, *Improving the Economic Foundations of Competition Policy,* 12 Geo. Mason L. Rev. 1 (2003).

[26] *See, e.g.,* Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 Yale L.J. 941 (2002) (discussing how a monopolist with a cost advantage over its potential rivals might deter entry despite its high pre-entry price); Dennis W. Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. Econ. 194 (2002) (discussing how firms can use the tying of

explain everything explains nothing. As Nobel laureate Ronald Coase said, "One important result of this preoccupation with the monopoly problem is that if an economist finds something -- a business practice of one sort or another -- that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of understandable practices tends to be rather large, and the reliance on a monopoly explanation, frequent."[27]

Thus, while it is possible that the developing theoretical literature on the anticompetitive uses of bundling may ultimately inform sensible antitrust policy, a review of the current literature on bundling reveals that this time has not yet come. In the same way that a visitor from Mars who reads only the mathematical IO literature could mistakenly conclude that the U.S. economy is rife with monopoly power, it would be a mistake to infer that the growing volume of theoretical papers examining bundling or bundled rebates as an exclusionary device implies that there is *any* growing or significant danger from the anticompetitive use of bundling.[28] In contrast to the well developed and balanced literature that has informed antitrust policy in areas such as exclusive dealing, vertical restraints generally, and low-cost pricing,[29] the "relatively recent and sparse" literature on the use of bundling for exclusionary purposes is underdeveloped. *See* Brief of the United States as Amicus Curiae, *3M Co. v. LePage's Inc.*, 2004 WL 1205191, at 12 n.9 (May 28, 2004). This literature is highly selected, abstract, and almost exclusively theoretical. The theories and highly specific assumptions contained in these papers have not undergone rigorous empirical testing. Thus, while some of these theories raise the *possibility* of anticompetitive harm, they do not show that such harm is likely. We do not

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complementary products to create or protect monopoly power); Michael L. Katz, *The Welfare Effects of Third-Degree Price Discrimination in Intermediate Goods Markets*, 77 Am. Econ. Rev. 154 (1987) (finding possible benefits of forbidding third-degree price discrimination when bargaining power of chain stores comes from their ability to credibly threaten to integrate backward into the supply of intermediate goods); Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 Am. Econ. Rev. 837 (1990) (discussing possible exclusionary effects of certain tying arrangements).

[27] Ronald H. Coase, *Industrial Organization: A Proposal for Research, in Policy Issues and Research Opportunities in Industrial Organization*, 59, 67 (Victor R. Fuchs, Ed., 1972); *see also* Muris, n.25 supra at 12-13 (noting the contributions of empirical research and the consensus -- especially among empiricists -- that significant market power "problems" are special cases, not the norm).

[28] One illustration of this confusion is Judge Posner's statement that "[t]he usual purpose of bundling, as of tying, is price discrimination." Richard Posner, 72 U. Chi. L. Rev. at 235. Clearly, academic economists frequently studied the theoretical use of bundling as a price discrimination device. Interest in this literature was prompted by Professor Stigler's use of price discrimination to provide an alternative to the leverage theory contained in the Court's analysis of block booking by the film studios in *United States v. Loew's*, 371 U.S. 38 (1962). In depth studies of the use of block booking in both the Loew's and Paramount cases have rejected both the leverage and price discrimination theories. *See* Kenney and Klein, supra n.15 at 533-34, Roy W. Kenney & Benjamin Klein, *How Block Booking Facilitated Self-Enforcing Film Contracts*, 43 J. L. & Econ 427 (2000); F. Andrew Hanssen, *The Block Booking of Films Reexamined*, 43 J. L. & Econ. 395 (2000). Thus, Judge Posner's statement conflates academic interest in an interesting but empirically unsupported theory to explain block booking with the frequency of this practice. As noted in Section I above, the usual purpose of bundling is likely the result of the obvious and transparent explanations based on cost savings.

[29] For a recent review of this literature, *see* James C. Cooper, Luke Froeb, Daniel P. O'Brien & Michael Vita, *A Comparative Study of United States and European Union Approaches to Vertical Policy*, Vanderbilt University Law School Law and Economics Working Paper 05-11 (2005).

know whether such harm exists outside of the articles and working papers of academic economists.

Nor does the current literature provide any reliable way to trade off the theoretical risk of exclusionary harm against the efficiency gains from bundling. As noted earlier, there are many well known and obvious efficiency benefits of bundling. Nevertheless, the microeconomic and industrial organization literature has paid almost no attention to these benefits, largely because the obvious and transparent nature of these efficiency explanations makes them unlikely subjects for academic articles. One does not get tenure or advance his academic career through focus on the obvious. *See* Evans and Salinger, 22 Yale J. on Reg. 37 (2005). Moreover, there may be efficiency benefits from bundling that are less obvious.[30] These, too, have been largely ignored by academics to date. Indeed, many theoretical articles on bundling explicitly ignore efficiency considerations for the specific purpose of focusing the readers' attention on the *potential* for anticompetitive harm. The literature thus reflects subjects that interest academic economists rather than a representative or comprehensive explanation for bundling.

Even ignoring the potential efficiencies of bundling and the lack of empirical evidence supporting the existence of anticompetitive harm from bundling, it is not clear that these new theories support increased scrutiny of bundling by dominant firms. Much of the exclusionary or entry deterring conduct by dominant firms would increase consumer welfare, even under the narrow models studied. For example, Professor Nalebuff examines the use of bundling as an entry barrier, Barry J. Nalebuff, *Bundling as an Entry Barrier*, 119 Q. J. Econ. 159 (2004), and shows that pure bundling could be an effective entry deterrent strategy. The paper, however, examines entry independent of the effect of bundling on economic welfare.[31] Yet welfare with bundling almost always rises relative to the no-bundling equilibrium, including cases in which bundling results in marginal entry deterrence. *See* Timothy J. Brennan, *Competition as an Entry Barrier? Consumer and Total Welfare Benefits of Bundling*, Mimeo (2005). Similar results hold in the literature on exclusionary bundling. *See, e.g.*, Barry J. Nalebuff, *Exclusionary Bundling*, Mimeo, Yale University (2004) (noting that static welfare increases in example of exclusionary bundling).

Thus, any reliance on the theoretical exclusionary literature to prohibit or regulate bundled discounts is premature. While the economic literature suggests the *possibility* of anticompetitive harm from certain bundling, there is little evidence that such harm is likely or that any potential for harm would outweigh any demonstrable benefits from the practice. The current IO literature, therefore, does not supply a reliable way to distinguish uses of bundling that are on net procompetitive from those that are anticompetitive. Accordingly, any rule that condemned such a ubiquitous and beneficial practice without requiring an explicit showing of likely harm to competition in each particular case where liability is sought, or, more broadly, as a rule of general

[30] *See* Kenney & Klein, supra n.14 (discussing the use of block booking as a way to reduce agency costs and information costs).

[31] For a general criticism of this approach to barriers to entry, *see* Harold Demsetz, *Barriers to Entry*, 72 Am. Econ. Rev. 47 (1982); C.C. von Weizsacker, *A Welfare Analysis of Barriers to Entry*, 11 The Bell J. of Econ. 399 (1980).

applicability, in the vast majority of cases would result in the widespread condemnation of efficient practices. Such a result would be particularly damaging to the economy as it would chill the very conduct the antitrust laws are designed to protect. *See Verizon Communications v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 407 (2004).[32]

III. The Third Circuit's Approach in *LePage's v. 3M* to Bundled Pricing by Firms with Market Power Is Legally Flawed and Will Likely Deter Proconsumer Behavior

Unfortunately, there is now prominent case law that condemns bundling based on speculative theories of anticompetitive harm. In a controversial *en banc* decision decided just over two years ago, the Third Circuit exposed to potential antitrust liability *any* dominant firm that offers customers rebates or discounts on the purchases of a bundle of goods also sold separately. *LePage's, Inc. v. 3M*, 324 F.3d 141 (3rd Cir. 2003), *cert. denied*, 124 S.Ct. 2932 (2004). The Third Circuit held that a bundled rebate can constitute the unlawful exercise of monopoly power even in the absence of any evidence that the monopolist's prices were below its costs. Thus, the Third Circuit exposes to liability under the antitrust laws pricing conduct that does not constitute predatory pricing under *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). By divorcing the law governing bundled pricing from the law governing predatory pricing, *LePage's* has created considerable uncertainty and mischief in an important area of antitrust law. The effects of uncertainty were magnified by the incomplete nature of the record and by the fact that the Third Circuit failed to articulate clearly what aspect of 3M's bundled rebates constituted exclusionary conduct. *See* Brief of the United States as Amicus Curiae, *3M Co. v. LePage's Inc.*, 2004 WL 1205191, (May 28, 2004) at 8.

In *LePage's*, 3M had offered retailers large discounts if they purchased certain volumes of various 3M products. The size of the bundled rebates increased when retailers met volume goals across six product categories.[33] LePage's, another tape manufacturer, but one with only one product to offer (private label tape), sued 3M, claiming that the bundled discount was so large that many stores would not purchase LePage's tape. The en banc Third Circuit held 3M's bundled discount practice unlawful, even though the record contained no evidence that any of 3M's products were sold below its costs, because the practice by a firm dominant in tape drove some retailers away from

[32] For a recent example of such an effect, *see, e.g., McKenzie-Willamette Hospital v. PeaceHealth*, D. Or. Case No. 02-6032-HA, Jury Instruction at 33:18-34:3 (jury instruction stating that "bundled pricing occurs when price discounts are offered for purchasing an entire line of services exclusively from one supplier. Bundled price discounts may be anticompetitive if they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not provide an equally diverse group of services and who therefore cannot make a comparable offer."). The jury found for the plaintiff on an attempted monopolization claim based on the PeaceHealth's use of Preferred Provider Organization contracts that gave discounts to insurers that used PeaceHealth's primary and tertiary hospital services. Plaintiff McKenzie did not provide tertiary services. *See* 2004 WL 3168282 (D. Or.) (denial of renewed motion for directed verdict).

[33] The six product categories included stationery products (which included other products such as 3M's Post-It notes in addition to transparent tape), Home Improvement (sponges), Leisure time (audio-visual products), Home Care Products, Health Care Products, and Retail Automobile Products. *LePage's*, 324 F.3d at 154.

the purchase of LePage's tape. In the Third Circuit's view, it was immaterial whether LePage's or any hypothetically efficient competitor could meet 3M's discount without pricing below its cost. While the Third Circuit suggested the possibility that 3M's bundled rebates could exclude an equally efficient competitor, it did not cite any evidence on LePage's relative costs.[34] Nor did it cite any evidence showing that LePage's was unable to match the discounts that resulted from 3M's various pricing programs. Nor did the Third Circuit explain why discounts that would exclude higher cost competitors were anticompetitive.

Rather, the Third Circuit concluded that it was sufficient for LePage's to prove that it could not compete with 3M's bundled rebates because "they may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer." *LePage's*, 324 F.3d at 155. The Third Circuit considered 3M's attempt to rebut that presumptive rule of liability, but found no evidence in the record that the bundled rebates had a legitimate business justification. *Id.* at 164.

That ruling is both mistaken and harmful to consumers:

First: The Third Circuit's rule unjustifiably protects higher cost competitors. The Third Circuit did not require LePage's to prove that it could make tape as efficiently as 3M, or even that 3M's conduct would have excluded a hypothetical equally efficient competitor. The result is that a plaintiff need not establish this element in its prima facie case, and a business cannot defend itself against a bundling claim on this ground. For purposes of litigation and advising a client about the legality of its pricing practices, that result is quite severe, because it jeopardizes any dominant business that uses bundled discounts and increases its market share as a result. Indeed, perhaps the Third Circuit's decision is even worse because, as the dissent noted, LePage's expert conceded that LePage's was not as efficient at producing tape as 3M. *LePage's*, 324 F.3d at 177 (Greenburg, J., dissenting). Thus, the Third Circuit's rule will allow inefficient firms that would have been driven out of business due to their higher costs to successfully sue dominant firms that use bundled discounts. Moreover, the Third Circuit's decision took a narrow view of what constituted cognizable efficiencies for purposes of judging whether 3M had a valid business justification for its pricing programs.[35] "In general, a business justification is valid if it relates directly or indirectly to the enhancement of consumer welfare."[36] By recognizing only a narrow set of potential cost reductions, the Third

[34] The concept of "equally efficient" must be applied with great care to bundled discount cases. *See* Brief of U.S. at 13 (noting difficulties in defining the term) and the discussion below at 17-18, 24-5, *infra.* Indeed, there may be cases where the advantages of bundling to consumers or producers are so great that a single-product firm cannot be said to be equally efficient regardless of its costs. The reverse proposition does not hold: A single product firm can be obviously inefficient, even comparing its costs to its multi-product competitor's costs of producing just the one product in which both compete. It is important to add that the record in *3M* is incomplete; as discussed below, it does not provide evidence on important factual issues. Moreover, bundling in other industries will potentially contain important factual distinctions with the practices in *3M.* For example, competitive and entry conditions may differ, as will the relationship of ~~the bundle to ultimate consumers.~~

[35] *LePage's*, 324 F.3d at 164.

[36] *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1183 (1st Cir. 1994).

Circuit implicitly ignored the increases in consumer welfare that result from bundled discounts. Such a rule stands antitrust on its head by seeking to protect competitors in cases where doing so deprives consumers of the benefits of bundled discounts and prevents dominant firms from using bundles that increase consumer welfare.

This outcome is bad economics and bad law. As a matter of economics, liability rules based on speculative theories of harm applied to a ubiquitously used practice will likely result in widespread false positives that condemn efficient practices. As a matter of antitrust law, Sherman Act § 2 should not safeguard less efficient firms or punish more efficient ones, even if they are monopolists. *See Spectrum Sports v. McQuillen*, 506 U.S. 447, 458 (1993) (the Sherman Act does not "protect businesses from the working[s] of the market"); *Cargill, Inc. v. Montfort of Colorado, Inc.*, 479 U.S. 104, 116 (1986) ("[T]he antitrust laws do not require the courts to protect small businesses from the loss of profits due to continued competition . . . . The antitrust laws require no such perverse result, for it is in the interest of competition to permit dominant firms to engage in vigorous competition, [even] price competition.") (internal punctuation omitted).

Just last year, the Supreme Court reiterated that possession of monopoly power itself is not illegal, or even socially undesirable. "The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices – at least for a short period – is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth." *Trinko*, 540 U.S. at 407.[37] As Judge Posner has explained, § 2 should deem exclusionary only that conduct by a monopolist that both is capable of excluding an equally or more efficient rival and also cannot be justified on efficiency grounds. Richard A. Posner, *Antitrust Law* 194-95 (2d ed. 2001) (proposing that test for judging practices claimed to be exclusionary); Richard Posner, 72 U. Chi. L. Rev. at 239-40 ("[T]he antitrust concern is with the exclusion of equally or more efficient competitors.") (footnote omitted).

Second: The Third Circuit's rule is impermissibly vague. By eschewing reliance on the settled legal test governing predatory pricing adopted in *Brooke Group* to hold unlawful 3M's pricing strategy, and by doing so without endorsing another clearly-defined, generally-applicable, and easily administrable legal standard, the *LePage's* decision makes it virtually impossible to determine which bundles are permissible because juries will be handed the task of differentiating between lawful and unlawful

[37] At one time, it was thought that a monopolist could not expand to meet demand for its product due simply to its status as a monopolist. *See United States v. Aluminum Co. of America*, 148 F.2d 416, 431 (2d Cir. 1945), in which Judge Hand condemned Alcoa's deliberate expansion of its own capacity to meet demand. That aspect of *Alcoa*, however, has long been rejected because it encourages inefficient conduct, by preventing a dominant firm from competing against less efficient firms. Richard A. Posner, *Antitrust Law* 262-63 (2d ed. 2001); *see Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340-41 (1990); *Cargill, Inc. v. Monfort of Colorado Inc.*, 479 U.S. 104, 116 (1986); *United States v. Syufy Enterprises*, 903 F.2d 659, 668-69 (9th Cir. 1990); *United States Football League v. National Football League*, 843 F.2d 1335, 1360 (2d Cir. 1988); *Olympia Equip. Leasing Co. v. Western Union Telegraph Co.*, 797 F2d 370, 375-76 (7th Cir.), *supplemented on denial of rehearing*, 802 F.2d 217 (1986); *Bayou Bottling, Inc. v. Dr. Pepper Co.*, 725 F.2d 300, 304 (5th Cir. 1984); *Berkey Photo Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274 (2d Cir. 1979).

bundling practices without being given a clear and understandable rule to apply. In so holding, the Third Circuit has created enormous uncertainty regarding the antitrust liability of companies that use bundled discounts and that possess significant market shares in one or more of the bundled products.

IV. The Different Theories Purporting to Explain Why Bundled Discounts can be Anticompetitive and Should be Restricted When Used by Dominant Firms Are Unpersuasive, Lack Empirical Foundation, or Both

If the Third Circuit's approach in *LePage's* to bundled pricing is not a sensible one, the question becomes, what approach is? As I explain below, given our current state of knowledge, the best approach to multiproduct bundled discounts is a modified version of the one adopted by the Supreme Court in *Brooke Group* to determine whether a single-product discount amounts to predatory pricing. I discuss different theories that have been advanced to explain why multiproduct bundling by dominant firms can be anticompetitive and therefore should be prohibited or restricted. This section also discusses the Court's *Brooke Group* approach as applied to bundled discounts.

A. Bundling as Predation Through Profit Sacrifice

One theory is that a dominant firm could use a bundled discount to sacrifice short-term profits to force rivals to sell at an unprofitable price or to operate below their minimum viable scale. *See, e.g.*, Daniel L. Rubinfeld, 72 U. Chi. L. Rev. at 254-55 (describing theory). So phrased, this approach can be best understood either as applying traditional predatory pricing theory to multiproduct bundles or, if it is intended to be something different, as a means of bypassing and negating traditional predatory pricing theory to achieve an inconsistent result. Predatory pricing describes the practice in which a business reduces the price of its goods below an appropriate measure of cost (such as marginal cost or average variable cost) in the short run to drive a competitor from the market in the hope of capturing monopoly profits in the long run. *See, e.g., Brooke Group*, 509 U.S. at 224; *Cargill*, 479 U.S. at 117; Phillip E. Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697, 698 (1975).[38] In any event, we know that successful predation, though theoretically possible,[39] is rare, and the likelihood that a firm will attempt predation through price decreases is low.[40] Furthermore, antitrust liability for predatory pricing has

[38] By contrast, short-run below cost pricing done for the promotion of new goods or services is common and generally thought not to be predatory. Phillip E. Areeda & Donald F. Turner, 88 Harv. L. Rev. at 713; Daniel A. Crane, 72 U. Chi. L. Rev. at 41 n. 48.

[39] *See, e.g.*, Paul Milgrom and John Roberts, *Predation, Reputation, and Entry Deterrence,* 27 J. Econ. Theory 280 (1982) (model showing successful predation is possible if there is a small probability that the predator is irrational).

[40] *Brooke Group*, 509 U.S. at 220-24; *Matsushita*, 475 U.S. at 588-90; Herbert Hovenkamp, *Exclusive Joint Ventures and Antitrust Policy*, 1995 Colum. Bus. L. Rev. 1, 81 ("Predatory pricing is an extraordinarily expensive and risky way to create market power."); Robert Bork, *The Antitrust Paradox* 145 (1978); Richard Posner, *The Chicago School of Antitrust Analysis*, 127 U. Pa. L. Rev. 925, 939-40 (1979); Phillip E. Areeda & Donald F. Turner, 88 Harv. L. Rev. at, 699 (concluding that predatory pricing is unlikely to succeed or be tried because a predatory firm will not be able to recoup its losses in most cases); Frank

the potential to chill aggressive price competition that would increase consumer welfare. In balancing these considerations for the single product case, the Supreme Court, set out a "not easy to establish" rule in *Brooke Group* and *Matsushita.* Under this rule, plaintiffs in predatory pricing cases must prove that the prices complained of are below an appropriate measure of its rival's costs, and must demonstrate that the competitor had a reasonable prospect, or under Section 2, a dangerous probability, or recouping its investment in below cost prices.

Given this existing law, is there any reason to create a new liability theory for predatory bundled pricing? While bundled predatory pricing may present some new issues, it is far from clear that such issues would be resolved differently.[41] As noted above, bundled discounts are ubiquitous and provide significant benefits to consumers and producers. These include not only the benefits to consumers that result from the lower prices, but also the direct benefits of bundling that, for example, allow consumers and producers to reduce transactions and information costs. Thus, any rule that did not create a broad safe harbor for bundled discounts would run a significant risk of deterring procompetitive and proconsumer behavior. And, based on current knowledge, any marginal risk of predation through bundled pricing would at best be speculative.[42]

Can the Court's rule in *Brooke Group and Matsushita* be rationally applied in the case of bundled discounts? One possible way to apply the rule adopted in those cases to this context is to allow bundled discounts as long as the price of the bundle exceeds the sum of the separate costs of the constituent elements. Put another way, if the total price of the bundle exceeds the total cost of its constituents (taking into account the efficiencies directly attributable to bundling), the firm has not engaged in predatory bundling. As discussed below, the primary advantages of such a rule would be that it is administrable and predictable, and would be the least likely to pose undue risks of overdeterring procompetitive behavior.[43]

Some have criticized such a rule as too permissive. However, any alternative would have serious flaws. For example, one could attempt, for purposes of carrying out a

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Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263, 333-34 (1981) (describing the difficulties of proving that a predator could recoup his damages in future periods); David S. Evans & A. Jorge Padilla, 72 U. Chi. L. Rev. at 87; John R. Lott, Jr., *Are Predatory Commitments Credible?: Who Should The Courts Believe?* (1999) (predation by private enterprises is implausible, but predation by public enterprises is not); John S. McGee, *Predatory Pricing Revisited*, 23 J. Law & Econ. 289, 295-297 (1980); William H. Page, *The Scope of Liability for Antitrust Violations*, 37 Stan. L. Rev. 1445, 1472-73 (1985) ("[T]here are great inherent disincentives to [the use of boycotts and predatory pricing], and the circumstances in which they are profitable are rare."); *see* Richard A. Epstein, *Monopoly Dominance or Level Playing Field? The New Antitrust Paradox*, 72 U. Chi. L. Rev. 49, 61 (2005); *id.* at 63-64 ("the short-term consumer benefits from this practice [*i.e.*, alleged predatory pricing] more than offset any remote risk that the seller will (at some future and uncertain time) obtain a monopoly by driving all rivals out of the field") (footnote omitted); John S. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J. L. & Econ. 137 (1958).

[41] *See, e.g.*, Daniel Crane, 72 U. Chi. L. Rev. at 42 (noting that "[p]ricing below cost through a unilateral price cut on a single product is more likely to be exclusionary than effectively pricing below cost on a single product subject to a package discount." (footnote omitted).)

[42] Other anticompetitive theories of bundling are addressed in Parts B and C of this Section.

[43] *See* the discussion in Section VI, *infra.*

predation test, to allocate the bundle discount between the component goods. The problem with this approach is that there is no consensus, in theory or practice, on how to make such allocations. The problem requires, among other things, that the court allocate joint and common costs among the products contained in the bundle. Unless this is done arbitrarily (e.g., via an arbitrary pro-rata rule) such a task is likely to be an administrative nightmare for the courts.[44] An arbitrary allocation runs the risks of numerous mistaken applications.

One variant of the *Brooke Group* rule applied to bundled pricing would be to provide a safe harbor for a bundled discount when, after attributing the entire bundle discount to the plaintiff firm's product market, the effective price in the plaintiff's market is above the relevant measure of the monopolist's cost of producing that product. Such a rule would be equivalent to adopting a safe harbor for bundled discounts as long as they would not exclude or drive out of business a hypothetical equally efficient competitor. Although it has some appeal, as discussed in more detail below, even this standard is flawed. For example, it fails to protect from liability bundled discounts that raise welfare.[45] Moreover, given the absence of an alternative standard, implementation of such a weak safe harbor may result in its de facto use as sufficient grounds for condemning bundled discounts that do not lie within the safe harbor.[46]

B. Bundling as a *De Facto* Form of Tying

David Sibley, the former Deputy Assistant Attorney General of the Justice Department Antitrust Division, and his co-authors have proposed a different test under which a bundle should be deemed unlawful when it is used to obscure a price increase in the cost of individual constituent items. The harm to consumers comes in the form of a "de facto" or so-called "contractual" tie-in: While a consumer can purchase each component of a bundle separately, the prices of the separate components are increased relative to the component prices without bundling. This price increase makes purchase of the bundle relatively attractive, even when the prices in the bundle are set at the monopoly level. The bundle appears to offer consumers a discount, but in fact does not, because the price for each separate good has been correspondingly increased, including raising the stand-alone price of the monopoly good above the monopoly price of the good in the absence of bundling. The authors argue that such a bundle offers no benefit to consumers and simply disguises an increase in the price of the component goods. This theory holds a bundled pricing scheme unlawful as a "de facto" tie when its use results in higher prices for the component goods and a reduction in consumer and total welfare. Patrick Greenlee, David Reitman & David S. Sibley, *An Antitrust Analysis of Bundled Loyalty Discounts,* Mimeo (October 2004); *see also* Phillip E. Areeda, Herbert

[44] For a discussion of the difficulty of this problem, see, e.g., S. J. Brown and David S. Sibley, *The Theory of Public Utility Pricing*, Cambridge University Press, (1986) at 44 (stating that the allocation of costs for ratemaking purposes "is not a straightforward task and is the source of many of the most muddled, lengthy and unsatisfactory proceedings in regulatory history."

[45] *See* the discussion in Section VII, *infra.*

[46] ~~Indeed, Professor Hovenkamp suggests that the hypothetical equally efficient competitor standard be~~ used as the basis for determining liability. See Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* 749 (2005 Supp.).

Hovenkamp & Einer Elhauge, 10 *Antitrust Law* ¶ 1758a, at 324 (1996) (discussing de facto tying); Daniel L. Rubinfeld, 72 U. Chi. L. Rev. at 252 & n.47 (discussing Greenlee, et al. theory).

Greenlee, et al. conjecture that the facts in the Third Circuit's earlier decision in *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (1978), which held that Eli Lilly's use of bundled rebates violated Section 2 of the Sherman Act, are consistent with the use of bundled rebates as a "de facto" tie. The authors postulate that the *SmithKline* Court, which applied an equally efficient competitor test, came up with the right decision for the wrong reasons.[47] They reject the equally efficient competitor test because it does not reliably distinguish between uses of bundling that increase consumer welfare and those that do not.[48] Under their alternative analysis, the use of bundled rebates by Eli Lilly to market cephalosporin antibiotics to hospitals violates the antitrust laws because Eli Lilly raised the stand-alone prices of cephalosporins purchased outside of their revised bundled rebate program.[49] To the extent "de facto" ties can be reliably differentiated from the more common use of bundled discounts -- a perhaps dubious proposition in the real world of trial courts -- this test could allow such de facto ties to be condemned, perhaps under the existing tying doctrine, without endangering the more common and welfare increasing use of bundled discounts.

As noted above, however, such a showing was not made, nor is required under the Third Circuit's holding in *LePages*.[50] Moreover, even if it was required, such a test would be problematic in that it requires that courts know what the monopoly price would be in the absence of bundling. This task, while well defined in a theoretical model with a monopolist facing a known and stable demand, will be much more difficult to administer in practice.[51] Another problem is that the theoretical models of de facto tying presume the bundling firm has an actual monopoly. In practice, dominant firms rarely sell 100% of a product. Little is known about the viability of the de facto tying strategy when the bundling firm faces some competition in both markets. Under the antitrust laws, however, even firms with competition in all markets can be found to posses "market power," which is often equated with "monopoly power."[52]

Moreover, as noted above, this theory and its underlying assumptions have not been tested empirically. As a result, a rule that allowed plaintiffs to proceed on this

[47] See Greenlee, et al., Section V. Their rejection is based on error costs, because such a rule can condemn welfare increasing bundles, as well as fail to condemn welfare decreasing bundles.

[48] For a further discussion of the shortcomings of this test, see the discussion in Part C of this Section.

[49] Greenlee, et al., note that Lilly's revised rebate program reduced the rebate under their preexisting volume discount program by 3%. This reduction was offset by an additional 3% rebate to hospitals that purchased more than the individualized minimum amounts of three out of the five Lilly cephalosporin products.

[50] *But see Ortho Diagnostic Systems, Inc., v Abbot Labs., Inc.* 920 F. Supp. 455, 471 (1996) holding that defendant's discount pricing of products purchased in packages did not violate Sherman Act. The district court noted that "In order to defeat a properly supported motion for summary judgment, a party may not rest on economic theories that may or may not apply to the facts of the case or on conclusory or incomplete expert analyses any more than it may rest on unsubstantiated allegations of its pleadings."

[51] *See* the discussion in Section V, *infra*.

[52] *See* the discussion in Section VII, *infra*.

theory would likely condemn behavior in situations where the underlying assumptions of the model do not hold, and without empirical evidence that such anticompetitive effects are likely. We should not condemn practices that we know are beneficial in most circumstances without evidence of their actual anticompetitive effect in real world cases. Based on preliminary results from experimental tests of the Sibley theory, exclusionary bundling that reduces welfare is extraordinarily difficult to find. *See* Smith, et al., *Preliminary Results on Exclusionary Bundling*, ICES (2005). The existence of a negative effect on consumers is both limited and highly sensitive to the parameters used in the experiments, including the absence of any efficiencies from bundling and any competition in the monopoly product.

C. Bundling as Exclusionary Conduct by a Dominant Firm

A related challenge to bundling is that, even if its components are sold above-cost, the discount could exclude equally- or more-efficient competitors from entering or remaining in one or more component markets.[53] In the relevant models, the observed "injury" is to competitors. Under this theory, a one-product competitor could sue a dominant firm – that is, for example, one firm sells only bottled water, while another sells both bottled water and cola. The competitor could challenge the bundling practice on the ground that it was as efficient as the dominant soft drink firm, yet could not compete with the latter's bundles, because the size of the discount consumers received from the latter kept distributors (or consumers) from switching beverage purchases from soft drinks to bottled water. The Third Circuit endorsed such an antitrust theory in *LePage's* and in *SmithKline,* as have some lower courts outside of the Third Circuit.[54]

This theory is flawed as a basis for antitrust liability. The primary reason is that, as discussed in Section II, these models usually predict that both consumer and total welfare increase when exclusion occurs due to bundled discounts. When welfare increases, liability should not automatically follow, regardless of the relative costs of the excluded competitor. Critics of the consumer or total welfare standard note that the claims that welfare increases measure only short run welfare. These critics argue that the use of multiproduct bundled discounts to drive rivals from the field allows the bundling firm to garner monopoly profits in the long run. Thus, these critics claim that long run welfare should be used, even though it is not measured in the economist's formal model. While one could imagine such long-run harm, it seems even more unwise to condemn a ubiquitously used business practice because of the potential for harm that is not even specified in the theoretical model. Moreover, the ability to make general inferences or to formulate antitrust rules from models that explicitly examine long run or dynamic effects

[53] Professor Barry J. Nalebuff, for example, has written extensively on the potential anticompetitive practices associated with bundled pricing strategies. *E.g.*, Barry Nalebuff, ***Bundling as a Barrier to Entry***, 119 Q. J. of Economics 159 (2004); Barry Nalebuff, ***Bundling as a Way to Leverage Monopoly***, Yale School of Management Working Paper No. ES-36 (Sept. 1, 2004); Barry Nalebuff, ***Bundling, Tying and Portfolio Effects***, DTI Economics Paper No. 1 (Feb. 2003); Barry Nalebuff, ***Bundling***, Yale ICF Working Paper No. 99-14 (Nov. 22, 1999), Barry Nalebuff, ***Exclusionary Bundling***, Mimeo, Yale University (2004).
[54] *See, e.g., McKenzie-Willamette Hospital v. PeaceHealth*, D. Or. Case No. 02-6032-HA.

would be extremely limited.[55] Such models are either plagued by an inability to make specific predictions, or require strong assumptions to generate such predictions. As a result, the power of these models tends to be quite limited.[56]

Finally, the equally efficient competitor standard is itself flawed. The equally efficient competitor standard does not reliably differentiate between welfare increasing and welfare decreasing uses of bundling. Moreover, the standard is not well defined, and the exclusion of actual or hypothetical competitors with equal production costs may be the result of the inherent efficiencies of bundling.[57] For example, benefits to consumers of buying multiple items, rather than one, at a single time and place may overwhelm other considerations to the disadvantage of even an "efficient" single product firm. Nor does the standard consider that bundled rebates can lower the costs of distribution by lowering transactions costs and agency costs. For a manufacturer to increase the demand for its products, it may need to provide promotional and other point-of-sale services at the retail level of output. Yet, retailers may lack optimal incentives to provide such promotional and point-of-sale services. Because of potential free riding by retailers, manufacturers often supply or purchase such promotional resources. Promotional effort is often hard to monitor, however, and retailers can free ride by failing to supply the contracted-for promotional effort. Retailers also can free ride off the manufacturer's promotional investment by directing the manufacturer-supplied or manufacturer-purchased promotion to the sale of a rival's higher profit products.[58] Manufacturers can use bundled discounts to compensate retailers for their efforts on behalf of the manufacturer. By compensating those retailers that sell large volumes of the manufacturer's products, the use of bundled discounts can ensure that distributors and/or retailers of a manufacturer's goods have strong incentives to promote and sell these goods, and thus can serve to mitigate retailer free-riding and hold up problems.

Bundled rebates, therefore, can serve the same efficiency-promoting functions as has been identified in the literature examining the use of exclusive dealing and other forms of vertical restraints.[59] Indeed, others have noted the similarities between firms' use of bundled rebates and exclusive dealing.[60] Unlike exclusive dealing, bundled

[55] For an example of a model of dynamic effects, see, Dennis Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, 33 RAND J. Econ. 194 (2002). These authors, however, suggest that a "very cautious approach" to antitrust liability be taken based on such models. *See* Dennis W. Carlton & Michael Waldman, *How Economics Can Improve Antitrust Doctrine Towards Tie-In Sales*, 1 Competition Policy Int'l. 27 (2005).

[56] *See generally*, Sam Peltzman, *The Handbook of Industrial Organization: A Review Article*, 99 J. Pol. Econ. 201 (1991), Muris, supra n.25.

[57] *See* the discussion in note 34, *supra*.

[58] See, e.g., Benjamin Klein, Andres Lerner, & Kevin M. Murphy, *How Exclusive Contracts Protect Specific Investments Against Free Riding and Hold Ups*, ms (2005).

[59] *See, e.g.*, Howard Marvel, *Exclusive Dealing*, 25 J. L. & Econ. 1 (1982); Benjamin Klein, *Exclusive Dealing as Competition for Distribution "on the Merits,"* 12 Geo. Mason. L. Rev. 119 (2004) (analyzing the economics of exclusive dealing).

[60] *See LePage's*, 324 F.3d at 147 (bundled rebates characterized as *de facto* exclusive). *See also*, Richard A. Epstein, 72 U. Chi. L. Rev. at 63, Andrew Gavil, *Exclusionary Distribution Strategies by Dominant Firms: Striking a Better Balance*, 72 Antitrust L. J. 3 (2004), Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 Antitrust L. J. 615 (2000).

rebates do not prevent retailers from offering consumers other manufacturers' products. The retailers do not have to disappoint those consumers with strong preferences for competitors' products. This advantage of bundled discounts is likely to be important when retailers' point of sales services and consumers' demand for variety at the retail level are both important.[61]

V. Legal Rules Must, Above All, be Administrable by Courts and Not Pose Undue Risks for Business or Consumers

Judge Posner has argued persuasively that the goal of legal rules is to minimize the sum of direct costs and error costs.[62] Error costs include the costs of false negatives (or allowing anticompetitive conduct) and the costs of false positives (the costs wrongly condemning or deterring an efficient business practice). Direct costs include the costs imposed on society (including litigants, consumers, and the courts) associated with the administration of, compliance with, and litigation over the antitrust laws. The exact nature and content of the optimal legal rule will depend on the nature and size of these three types of costs.

For example, if the relative cost and frequency of false positives relative to false negatives is high, then the optimal rule should contain both procedural and substantive safeguards that reduce the costs of false positives. Examples of this include the procedural safeguards given to criminal defendants and the high burden of proof placed on prosecutors (due to the relatively high costs of false positives). Another example is the difficult burdens placed on antitrust plaintiffs in predatory pricing cases because price cutting is so ubiquitous in and important to our economy.

The nature of the direct costs also determines whether the optimal legal rule takes the form of a nuanced standard, or takes the form of a more easily administrable rule. Uncertainty in the application of nuanced standard can dramatically increase the direct costs associated with such a rule. Uncertainty can cause either under- or overcompliance with legal rules,[63] and can increase the frequency and cost of litigation.[64] As a result, it is often the case that legal rules optimally ignore potential or speculative harms because any attempt to address them would result in an increase in direct costs that far outweighed any benefit from the reduction in error costs.

As Justice (then-Judge) Breyer has explained,

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[61] *See, e.g.*, Benjamin Klein and Joshua Wright, *The Economics of Slotting Arrangements*, Mimeo (2004), (noting a similar dual function as an explanation for the use of category management instead of exclusive dealing).

[62] *See* Richard A. Posner, *Economic Analysis of Law 536 (*6th ed. 2002); *see also* Timothy J. Muris, *The Federal Trade Commission and the Rule of Reason: In Defense of Massachusetts Board*, 66 Antitrust L. J. 773, 775-77 (1998).

[63] *See, e.g.*, Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. L. Econ. & Org. 279 (1986).

[64] *See generally* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. Leg. Stud. 215 (1984).

> [U]nlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counterproductive, undercutting the very economic ends they seek to serve.

Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 234 (1st Cir. 1983).

Given our current state of knowledge, bundled discounts should be judged under the *Brooke Group* test for predatory pricing.[65] Applying the standard for rulemaking just discussed, the *Brooke Group* test is the most sensible one to use to gauge the legality of multiproduct bundled discounts whenever used, by large firms or small, or by firms in unregulated or regulated industries.[66] I discuss the *Brooke Group* test next.

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[65] In their brief urging the Supreme Court to deny certiorari in *3M v. LePage's*, the United States argued that "the better course at this time is to defer plenary review of the question whether to extend "the essential *Brooke Group* bright-line rule" to bundled rebates. While the considerations that motivated this Court's decision in *Brooke Group* may, upon further study, provide useful guidance in resolving the proper treatment of bundled rebates, the applicability of the *Brooke Group* approach to this business practice would benefit from further judicial and scholarly analysis." *See* Brief of the United States as Amicus Curiae, *3M Co. v. LePage's Inc.*, 2004 WL 1205191, (May 28, 2004) at 14-15. Given the defects in the record, the Government's position that the Supreme Court not decide this issue in 2004 was sensible. Given the negative effects generated by the *LePage's* decision, however, the government should provide some guidance to the courts during this period of uncertainty.

[66] It is important to note that the models that support scrutiny of multiproduct bundled discounts assume that the firm involved is a monopolist. In the case of the telecommunications industry, that is no longer true for the firms that comprise USTelecom. Firms in the telecommunications industry once thought to be dominant, even monopolists, because of their status as landline communications companies, no longer should be deemed monopolists in light of the changing nature of telecommunications. The FCC, for example, has recognized that, in addition to cable and DSL, "[b]roadband Internet access services are rapidly being developed or provided over technologies other than wireline and cable, such as wireless and powerline." *Communications Assistance for Law Enforcement Act and Broadband Access and Services*, Notice of Proposed Rulemaking and Declaratory Ruling, 19 FCC Rcd 15676, ¶ 37 n.82 (2004); *see also, e.g.*, Kathleen Q. Abernathy, Commissioner, FCC, *Promoting the Broadband Future*, Keynote Address at Supercomm Conference 2-3 (June 22, 2004) ("As a result of the consumer benefits and efficiencies, wireline telecommunications carriers, cable operators, wireless carriers, satellite operators, electric utilities, and others are racing to build out broadband networks"), *available at* http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-248688A1.pdf.; *Inquiry Concerning the Deployment of Advanced Telecommunications Capability*, Third Report, 17 FCC Rcd 2844, ¶¶ 79-88 (2002); *Triennial Review Order* ¶ 263 ("[T]he Commission also has acknowledged the important broadband potential of other platforms and technologies, such as third generation wireless, satellite, and power lines.") (citing *Third Section 706 Report 2002*, 17 FCC Rcd 2844, ¶¶ 79-88 (2002)); R. Mark, *Broadband over Power Lines: FCC Plugs*, In Internetnews.com (Apr. 23, 2003), http://dc.internet.com/news/article.php/2195621 (Chairman Powell: "[t]he development of multiple broadband-capable platforms – be it power lines, Wi-Fi, satellite, laser or licensed wireless – will transform the competitive broadband landscape."). Moreover, not only do these companies face new intermodal competition from (for example) wireless communication and VoIP, their ongoing intramodal rivalry often takes place via bundle versus bundle competition, which even critics of bundling find to be a particularly

VI. *Brooke Group* Established a General, Easily-Administrable, Bright-Line Below-Cost Rule for Predatory Pricing

Brooke Group involved an antitrust challenge to volume discounts on generic cigarettes. The Supreme Court decided finally to resolve the question, reserved in earlier decisions, of "whether recovery should *ever* be available . . . when the pricing in question is above some measure of incremental cost." 509 U.S. at 223 (emphasis in original) (quoting *Cargill*, 479 U.S. at 117 n.12, and *Matsushita*, 475 U.S. at 585 n.9). The Court rejected "the notion that above-cost prices that are below general market levels or the costs of a firm's competitors inflict injury to competition cognizable under the antitrust laws," *id.*, and stated unequivocally that "a plaintiff seeking to establish competitive injury resulting from a rival's low prices must prove that the prices complained of are below an appropriate measure of its rival's costs." *Id.* at 222. Among the reasons why the Court so ruled was its belief that above-cost discounting, which generally benefits consumers, "is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting." *Id.* at 223. The Court also concluded that any other rule would disserve the purposes of the antitrust laws. As the Court explained:

> Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition. . . . We have adhered to this principle regardless of the type of antitrust claim involved. As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting. To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. The antitrust laws require no such perverse result. *Id.* at 223 (citations and internal quotations omitted).

But the Court did not stop there. Because the concern of the antitrust laws is with the protection of competition, rather than competitors, the Court reasoned that socially-valuable price reductions should not be impermissible simply because they may harm the competitive status of a rival; some demonstrable injury to competition also must be proved. 509 U.S. at 224-25.[67] The relevant competitive injury, the Court explained, was

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proconsumer use of bundles. *See, e.g.*, Barry J. Nalebuff, *Competing Against Bundles*, Yale School of Management Working Paper Series H, No. 7 (2000) (noting nature of bundle versus bundle competition).

[67] "That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured: it is axiomatic that the antitrust laws were passed for the protection of competition, not competitors. Earlier this Term, we held in the Sherman Act 2 context that it was not enough to inquire whether the defendant has engaged in unfair or predatory tactics; rather, we insisted that

either driving a rival from the market in the hope of recouping short-term discounts via long-term monopoly pricing or disciplining a rival in the hope of persuading it to engage in supracompetitive oligopoly pricing. *Id.* at 225. Accordingly, the Court added the additional requirement that a plaintiff prove that the defendant had "a reasonable prospect" or "a dangerous probability" of recouping its investment in below-cost prices. *Id.* at 224. The mere fact of below-cost pricing, even if combined with the (nearly always present) theoretical possibility of recovery, the Court added, was insufficient. Without considerable proof of the likelihood of "sustained supracompetitive pricing" and recoupment – *i.e.*, "an estimate of the cost of the alleged predation and a close analysis of both the scheme alleged by the plaintiff and the structure and conditions of the relevant market," *id.* at 226 – a case should be summarily dismissed. *Id.*[68]

To prevent the antitrust laws from being used anticompetitively, the Court in *Brooke Group* established a generally-applicable, bright-line, two-part rule to analyze claims of predatory pricing: A defendant cannot be held liable under the antitrust laws based on an allegedly-unlawful price discount unless the reduction brings the firm's price below its cost (whether marginal or average cost). *Brooke Group*, 509 U.S. at 222-23. Moreover, even when a company engages in below-cost pricing, the firm still is not liable without substantial proof that the firm can and will recover its discounts by driving out of business, or disciplining into submission, rival firms that may be as efficient as the defendant, but lack sufficiently deep pockets to sustain below-cost pricing. *Id.* at 224-26.

VII. The *Brooke Group* Rule Should be Applied to Bundled Discounts

For several reasons, applying a modified *Brooke Group* test to multiproduct bundled discounts represents sound antitrust policy.

1. At the outset, it is important to recognize that, as Professor Richard Epstein has noted, antitrust claims attacking bundling discounts fall "between the cracks of the three violations that are normally included in the area of [§] 2 violations" – tie-ins, predatory pricing, or exclusive arrangements. Richard A. Epstein, 72 U. Chi. L. Rev. at 63. The critics of bundled discounts should bear the burden of establishing the justification for creating a new basis for antitrust liability. As noted above, the current academic

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the plaintiff prove a dangerous probability that [the defendant] would monopolize a particular market. Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws; those laws do not create a federal law of unfair competition or purport to afford remedies for all torts committed by or against persons engaged in interstate commerce." *Brooke Group*, 509 U.S. at 224-25 (citations and internal punctuation omitted).

[68] "Evidence of below-cost pricing is not, alone, sufficient to permit an inference of probable recoupment and injury to competition. Determining whether recoupment of predatory losses is likely requires an estimate of the cost of the alleged predation and a close analysis of both the scheme alleged by the plaintiff and the structure and conditions of the relevant market. . . . If market circumstances or deficiencies in proof would bar a reasonable jury from finding that the scheme alleged would likely result in sustained supracompetitive pricing, the plaintiff's case has failed. In certain situations - for example, where the market is highly diffuse and competitive, or where new entry is easy, or the defendant lacks adequate excess capacity to absorb the market shares of his rivals and cannot quickly create or purchase new capacity - summary disposition of the case is appropriate." *Brooke Group*, 509 U.S. at 226.

economic literature falls far short of showing the circumstances under which bundled discounts should be condemned under the antitrust laws.

2. Bundled discounts are not inherently anticompetitive – to the contrary, they are a ubiquitous and facially procompetitive practice. That proposition is consistent with the case law, *see, e.g., Jefferson Parish Hospital District No. 2 v. Hyde,* 466 U.S. 2, 25 (1984) ("there is nothing inherently anticompetitive about packaged sales"), and also makes economic sense, *see, e.g.*, Phillip E. Areeda, Herbert Hovenkamp & Einer Elhauge, 10 *Antitrust Law* ¶ 1758d1, at 330 (2004) ("a failure to recognize cost savings hospitably would overdeter the common, often procompetitive, and seldom anticompetitive package discount"). Unlike naked horizontal price-fixing agreements, for example, bundled discounts do not inherently threaten to reduce output and increase prices, which is the principal evil at which the antitrust laws are directed.

As noted at the outset of this submission, bundled discounts are a widespread practice through all sectors of our economy and used for procompetitive reasons by large, medium, and small-sized firms who sell goods, services, or both. The practice benefits producers, distributors, and consumers alike. That this practice is employed both by firms in competitive markets and by firms with some measure of market power is particularly significant. "[N]ondominant firms regularly engage in unilateral practices challenged under the antitrust laws. These include tying; vertical restraints such as exclusive contracts and exclusive territories; nonlinear pricing, including loyalty discounts; and aggressive price cutting. Practices that generate efficiencies where firms lack market power logically should generate those same efficiencies where firms possess market power. There is no economic reason to believe that these efficiencies become less important as firms acquire market power." David S. Evans & A. Jorge Padilla, 72 U. Chi. L. Rev. at 81-83 (footnotes omitted).

Recent theoretical models have hypothesized that bundling could harm consumers. But, while there is widespread evidence of the benefits of bundled discounts, empirical support for the anticompetitive hypothesis is virtually nonexistent. In this circumstance, we must use rules that err on the side of our actual knowledge, not our suspicions. A modified *Brooke Group* standard that would require plaintiffs to prove that the price of the bundle is below the relevant cost of the bundle provides such a rule. The Court's test for predatory pricing is tough to satisfy – intentionally so. Given what we know about the widespread benefits of bundled discounts, a test similarly hard to satisfy should be our goal.

The history of Section 2 enforcement should give one pause about formulating aggressive rules against what is, at bottom, an important form of price competition. The law's history has mostly been one of mistaken enforcement.[69] There is no single formulation of exclusionary conduct under Sherman Act § 2 that enjoys universal acceptance in the case law, or in the academic and economic literature. As Professor Hovenkamp recently explained: "Notwithstanding a century of litigation, the scope and meaning of exclusionary conduct under the Sherman Act remains poorly defined. No

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[69] *See, e.g.,* Timothy J. Muris, *The FTC and the Law of Monopolization,* 67 Antitrust L. J. 693 (2000).

generalized formulation of unilateral or multilateral exclusionary conduct enjoys anything approaching universal acceptance. About the best antitrust has been able to produce are rules designed for specific classes of cases, such as the cost rules governing predatory pricing, or the simple per se rules applied to naked boycotts." Herbert Hovenkamp, *Exclusion and the Sherman Act,* 72 U. Chi. L. Rev. 147, 148 (2005) (footnotes omitted). There is no single coherent legal theory explaining why monopolization should be deemed illegal, nor one verbal formulation that captures all of the unilateral conduct that has been deemed anticompetitive.

Anyone who supports the modified *Brooke Group* standard as the appropriate test for bundled discounts must confront the views of Professor Hovenkamp, who supports the result in *LePage's*, if not its reasoning.[70] Hovenkamp would condemn bundled discounts when the discounted package price is above the cost of the package if the incremental price of the competitively-supplied bundled good is less than the bundling firm's cost of producing it. In effect, Professor Hovenkamp's proposed test condemns above-cost bundled discounts if they would exclude a hypothetical equally efficient competitor.

Hovenkamp's approach to bundled rebates is not consistent with the general approach to package pricing elsewhere in his Treatise. Consistent with the modified *Brooke Group* standard, he would not condemn package discounts as long as the discounted price of the package exceeds the total cost of the package. In contrast, his approach to bundled discounts would attribute the entirety of the bundle discount to the competitively supplied good.

To illustrate the differences between the modified *Brooke Group* and Hovenkamp's bundled discount tests, consider the following example. Two goods, A and B, both have marginal production costs equal to 10. For simplicity, suppose that consumers demand one unit of both. In the absence of bundling, good A is sold by a monopolist at a price of 20. Good B is sold competitively at 10. Now suppose the A monopolist offers an AB bundle at 28. Under Hovenkamp's package pricing rule, the bundle price is not predatory, as the price of the bundle package (28) is above the cost of the bundle (20). Under his bundle discount standard, however, such a bundle could exclude a hypothetical equally efficient competitor, as he would have to offer 8 or less to make stand alone sales of B.

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[70] Hovenkamp concludes that the discounts in *LePage's*:

"[A]pparently did not produce significant cost savings, but did a great deal of harm to the only surviving competitor. As a result, the majority's treatment seems consistent with our definition of exclusionary conduct as acts that:

(1) are reasonably capable of creating, enlarging or prolonging monopoly power by impairing the opportunities of rivals; and

(2) that either (2a) do not benefit consumers at all, or (2b) are unnecessary for the particular consumer benefits that the acts produce, or (2c) produce harms disproportionate to the resulting benefits." Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* 749 (2005 Supp.)

Professor Hovenkamp would distinguish the two approaches based on the existence of a firm with near monopoly power in one of the component goods. As Hovenkamp explains:

> "In any event, the theory should not be extended to situations involving substantially smaller market shares or significant uncertainty about market definition. The defendant in this case [*LePage's*] was conceded to be the dominant firm with a historic market share of 90 percent in what appeared to be a well-defined market. Indeed, unless there is evidence of collusive behavior we would be reluctant to extend the doctrine to any situation in which there was at least one competing firm able to match the defendant's discount across all product lines." Phillip E. Areeda & Herbert Hovenkamp, 3 *Antitrust Law* ¶ 749, at 184.

Apparently, Hovenkamp would not apply his approach to bundled rebates to firms with historical market shares below 90 percent, where there is not a well defined market, or when "there was at least one competing firm able to match the defendant's discount across all product lines." Thus, he would presumably apply his approach to package pricing, which is consistent with the modified *Brooke Group* standard, in the vast majority of cases.

To the extent that Hovenkamp's limits are followed, his approach will be largely consistent with the one suggested in this comment, differing only in cases of near monopoly. Such an approach would limit, but not eliminate, false positives. As clear from the above example, Hovenkamp's approach to bundled discounts would prevent a dominant firm from offering a bundled discount that effectively lowers the price of a supracompetitively priced good. But such price reductions benefit consumers, even when the bundled discounts exclude competitors. The discount reduces price toward cost and may spur competing price reductions by other firms – results that doubtless benefit consumers in the short run and could benefit them in the long run as well. Moreover, in some cases, the Hovenkamp approach would impose liability on a dominant price-discounting firm even if a competitor could enter the market in which it does not presently compete, either by expanding its own product lines or by entering into a joint venture with another company. This oversight is serious. Either form of "self-help" is desirable and, all else equal, is preferable to chilling price discounting through antitrust liability. Unless entry in the market for the competitive product is difficult, the dominant firm cannot succeed for long in raising prices to supracompetitive levels. Because that is precisely what the *Brooke Group* standard requires, a new standard is unnecessary to gauge the legality of multiproduct bundled discounts.

An even more serious problem is whether Hovenkamp's suggested limits will be followed. While Hovenkamp would limit application of the hypothetical equally efficient competitor standard to cases of near monopoly, it is far from clear that antitrust plaintiffs and courts will adhere to such limits. While the possession of monopoly power in the relevant market is one of the two necessary elements in a Section 2 case, many courts use the term market power and monopoly power interchangeably. Market power, which is the ability to profitably raise prices above the competitive level for a sustained period of time, is a much broader concept than monopoly power, and is possessed by a large number of firms in a wide variety of markets.[71] Even when courts limit application of Section 2 to firms with "substantial market power," such a term will easily apply to a firm with historical market shares well below 90%. As a result, the costs of false positives and the deterrence of procompetitive behavior result from the use of the hypothetically equally efficient competitor are likely to be larger and more widespread.

3. Using treble damages liability to regulate multiproduct bundling poses a clear, sizeable, and unjustifiable risk of deterring procompetitive conduct. Although this is a general problem in antitrust law,[72] it is of especial concern in the area of price cutting. *See* William Baumol, *Predation and the Logic of the Average Variable Cost Test*, 39 J. of L. & Econ. 49, 51 (1996) ("In a world in which vigorous competition is all too easily mistaken for predation, and in which firms can unintentionally overstep the line, it is important to provide managers with guidelines as unambiguous as the issue permits, to enable them to tailor their decisions in a way that ensures compliance with the law and minimizes vulnerability to anticompetitive lawsuits intended to handicap vigorous competition.").

As the Supreme Court has explained, any exclusionary effect of an above-cost price cut on smaller competitors "either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting." *Brooke Group*, 509 U.S. at 224. Indeed, "[e]ven if the ultimate effect of the cut is to induce or reestablish supracompetitive pricing, discouraging a price cut and forcing firms to maintain supracompetitive prices, thus depriving consumers of the benefits of lower prices in the interim, does not constitute sound antitrust policy." *Id.* at 223-24; *see Trinko*, 540 U.S. at 414 ("Mistaken inferences and the resulting false condemnations 'are especially costly because they chill the very conduct the antitrust laws are designed to protect.") (quoting *Matsushita*, 475 U.S. at 594). As Justice (then-Judge) Breyer has explained, "the consequence of a mistake" in this area of law "is not simply to force a firm to forego legitimate business activity it wishes to pursue; rather, it is to penalize a procompetitive price cut, perhaps the most desirable activity (from an antitrust perspective) that can take place in a concentrated industry where prices typically exceed cost." *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d at 235.

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[71] *See, e.g.*, Benjamin Klein, *Market Power in Antitrust: Economic Analysis After Kodak*, 3 Sup. Ct. Econ. Rev. 43 (1993).

[72] "One problem that haunts most antitrust litigation * * * is that vigorous competition may look very similar to acts that undermine competition and support monopoly power. The resulting danger is that the courts will prohibit, or the antitrust authorities will prosecute, acts that appear to be anticompetitive but that really are the opposite. The difficulty is that effective competition by a firm is always tough on its rivals." William J. Baumol & Alan S. Blinder, *Economics: Principles and Policy* 425-26 (8th ed. 2000) (paragraph break omitted).

We should not deter above-cost price-cutting by alleged monopolists because consumers benefit when a monopolist lowers its prices. *See, e.g.*, Richard A. Epstein, 72 U. Chi. L. Rev. at 63-64 ("the short-term consumer benefits from this practice [*i.e.*, alleged predatory pricing] more than offset any remote risk that the seller will (at some future and uncertain time) obtain a monopoly by driving all rivals out of the field") (footnote omitted); Frank Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263, 336 (1981); *cf.* Phillip E. Areeda, Herbert Hovenkamp & Einer Elhauge, 10 *Antitrust Law* ¶ 1758a, at 324 (1996) ("Notwithstanding some adjustment for temporary promotions, cost savings, and disguised price competition, classifying package discounts as a tie can chill very common procompetitive conduct, even under the rule of reason.").

It is especially difficult to distinguish instances of anticompetitive bundling from cases of procompetitive bundling. As Judge Posner has explained, even if "there are decent theoretical reasons for concern that vertical restraints can have anticompetitive consequences," that outcome will occur "probably in only a small minority of cases in which they are employed. Yet even in suspicious cases there invariably are multiple possible economic reasons for a challenged practice – no responsible student of antitrust policy is about to suggest that bundling, discounting, exclusive dealing, volume discounts, consumer rebates, or even tying should be presumptively unlawful – and sorting out the reasons in particular cases will often be very difficult. It is easier to conjecture anticompetitive [reasons] for such practices than it is to determine the practices' actual or even (in contrast to cartel cases) likely economic consequences." Richard Posner, 72 U. Chi. L. Rev. at 240-41.[73]

4. The *Brooke Group* rule readily can be understood and easily applied by courts and lawyers alike. *Brooke Group* allows each firm to determine whether it is acting lawfully by comparing its own costs and prices. The *Brooke Group* rule *is* an improvement because it is administrable. It creates a safe harbor for which a business can qualify simply by using its own data. That approach is invaluable for businesses and for the lawyers who advise them. *See* Herbert Hovencamp, 72 U. Chi. L. Rev. at 148 ("A workable definition of exclusionary conduct under Section 2 of the Sherman Act * * * [inter alia] must be administrable by a court, perhaps in a jury trial."). And in contrast to the hypothetically equally efficient competitor rule, it does not carry a high risk of deterring procompetitive behavior.

5. Let us remember the benefits of bundled discounts. For example, because bundling results in price reductions and other efficiencies for consumers (*e.g.*, one bill for various products and services), as well as in efficiencies for companies (e.g., one delivery cost), those benefits should be weighed against the alleged harms from bundling. Moreover, bundling that allows companies to engage in differential pricing can advance social welfare when the alternative is monopoly *al a carte* pricing. William James

[73] Again, the theoretical economics literature provides no guide for policy. Modern industrial organization justifies concern about virtually any practice. *See* Timothy J. Muris, 12 Geo. Mason L. Rev. at 13-14, and discussion accompanying notes 26-27, *supra*. The theoretical literature on predatory practices alone is so vast that I once heard Judge Easterbrook say that the primary harm from predatory pricing involves the trees that died to produce the academic literature.

Adams & Janet L. Yellen, 90 Q. J. of Econ. at 494-95. As noted above, the models in the growing theoretical literature on the exclusionary uses of bundling have ignored the obvious and ubiquitous procompetitive benefits of bundling. Not surprisingly, the Third Circuit's decision in *LePage's*, in adapting these speculative theories to 3M's bundled rebates, made no effort to balance these socially valuable effects of multiproduct bundling against what it saw as being misuse of monopoly power. Professor Epstein made that point quite succinctly, explaining that the Third Circuit in *LePage's* "ma[de] no effort to net out the gains to consumers from the losses to LePage's in deciding either liability or damages." Richard A. Epstein, 72 U. Chi. L. Rev. at 71.

6. Let me end on this point: Suppose that I am wrong. Using the *Brooke Group* predatory pricing test for multiproduct bundled discounts may not eliminate all risk of anticompetitive conduct. After all, recent articles have identified some theoretical scenarios in which this practice could harm single-product competitors or firms that do not sell the entire line of goods or services packaged in one bundle by a dominant firm. Such harm to competitors, even if beneficial to consumers in the short run, could harm them eventually. What do we do then?

Let me make three points in response.

First: These concerns are theoretical. No empirical evidence exists to suggest that bundled discounts cause significant harm to consumers. The antitrust laws should be reluctant to impose treble damages awards (and massive litigation costs) based just on an untested, speculative theory of anticompetitive harm.

Second: As noted above, there are several shortcomings in the concerns expressed in those articles, including ambiguous or positive effects on welfare from conduct labeled anticompetitive or exclusionary, and the failure to address systematically both the procompetitive benefits of bundling and how one would trade off these benefits against the possibility of competitive harm. Moreover, these articles artificially restrict the strategies and counterstrategies available to real world market participants. They do not account for the likelihood that one or more firms could join to produce and distribute the full range of goods or services offered by the dominant firm; the formal models assume that no other firm will enter the market to replace firms that have left.

Third: In the face of such uncertainty, the most sensible rule remains the one that I identified above. Any other rule threatens to impose considerable costs on firms for doing what the antitrust laws ought to encourage – offering discounts to consumers. And those costs come in a package of three: costs on consumers from discounts foregone by companies' fearful of treble damages liability; costs from the mistakes of courts and juries in deciding which bundles are impermissible; and costs from the dead-weight losses stemming from the oftentimes immense expense of litigating antitrust cases. Because we value price competition so highly and because bundled discounts are such a prominent form of price competition, we should err well on the side of preserving these procompetitive benefits of lower prices.

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
	)	
AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Access Services	)	RM-10593

REPLY DECLARATION OF PARLEY C. CASTO
ON BEHALF OF SBC COMMUNICATIONS INC.

I. WITNESS IDENTIFICATION AND QUALIFICATIONS

1. My name is Parley C. Casto. I am the Executive Director – Industry Markets Special Access Product Management for SBC. On June 13, 2005, I provided a declaration in this proceeding in which I described my background and qualifications.[1]

II. PURPOSE AND SUMMARY OF DECLARATION

2. The purpose of this declaration is to respond to the factual allegations made by various parties in the opening round of comments in connection with arguments that: (i) special access customers have limited alternatives to SBC offerings; (ii) SBC grooming policies present a barrier to special access entry; (iii) SBC has an advantage over its rivals because it purportedly has

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[1] Declaration of Parley C. Casto on Behalf of SBC Communications Inc., filed in WC Docket No. 05-25 on June 13, 2005 ¶¶ 1-4 ("Casto Initial Decl."). Unless otherwise noted, all cites to Declarations and Comments refer to declarations and comments filed in WC Docket No. 05-25 on June 13, 2005.